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NOTE

FEDERAL CRIMINAL AND ADMINISTRATIVE CONTROLS FOR AUDITORS: THE NEED FOR A CONSISTENT STANDARD

Civil liability has become an accepted method of forcing compliance with the federal securities laws.¹ Recent court decisions have made accountants keenly aware that their auditing functions expose them to civil liability for misstatements and negligence.² The accountant, however, has been less aware of the other sanctions that may be imposed on him for failure to properly execute his auditing functions.³

1. Private civil actions have been implied under seven sections of the Securities Exchange Act. See *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) [§ 14(a)]; *Fishman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951) [§ 10-b]; *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944) [§ 6(b)]; *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949) [§ 15(c)]; *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949) [§§ 11(d)(2), 17(a)]; *Remar v. Clayton Sec. Corp.*, 81 F. Supp. 1014 (D. Mass. 1949) [Regulation T]. See also *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith*, 410 F.2d 135 (7th Cir. 1969); [violation of N.Y.S.E. Regulations]; *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd per curiam*, ___ F.2d ___, (2d Cir. 1969) [Regulation U].

2. See Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967), *cf. Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), *Globus v. Law Research Service, Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968).

3. Only five cases have been found in which federal criminal charges have been brought against auditors, all of whom were certified public accountants. In *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June, 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968), two partners and a senior associate of the international accounting firm of Lybrand, Ross Brothers & Montgomery were convicted of conspiracy and mail fraud in connection with their audit and certification of the 1962 financial statement of Continental Vending Machine Company. See *Wall St. Journal*, June 24, 1968, at 7, col. 1. Accountants were also convicted in *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964) and *United States v. White*, 124 F.2d 181 (2d Cir. 1941). The disposition of *United States v. Olen*, 183 F. Supp. 212 (S.D.N.Y. 1960) (motion for change of venue granted), is not known, although one of the defendants subsequently submitted his permanent resignation from further practice before the SEC. *In re Kerlin*, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966); In *United States v. Getchell*, 282 F.2d 681 (5th Cir. 1960), the defendant was acquitted on appeal.

The earliest criminal prosecution of an auditor which has been found occurred in England in 1931. See W. RICH, *LEGAL RESPONSIBILITIES AND RIGHTS OF PUBLIC ACCOUNTANTS* (1935) [Hereinafter cited as RICH]. In *Rex v. Kysant & Morland*, reported in RICH, at 100-09, Moreland, the auditor, was charged under section 84 of the Larceny Act of 1861, 24 & 25 Vict., c. 96., with certifying false financial statements for two years in order to permit the chairman of his client to sell a large issue of its debentures at a grossly inflated price. The chairman, Lord Kysant, had previously prepared the statements for inclusion in a prospectus. It was specifically

These other possible sanctions are the subject matter of this note. Criminal liability is discussed first. Disqualification from practice before the Securities Exchange Commission, the most serious federal administrative sanction, is considered in Part II.

I. CRIMINAL SANCTIONS

Initially, it should be noted that there are many statutes under which criminal liability may be imposed on accountants.⁴ Six statutes, however, hold particular significance for those involved in making up financial statements sent through the mails or filed with the government. They are: the false statement,⁵ mail fraud,⁶ aiding and abetting,⁷ and conspiracy⁸ statutes, and the criminal provisions of the Securities Act⁹ and the Exchange Act.¹⁰

charged that Kysant had lumped into the current profits account substantial secret revenues accumulated in prior years and profits from extraordinary sales of major corporate assets, creating the appearance of substantial earnings when in fact the company had been operating unprofitably. Kysant was convicted and the verdict was affirmed on appeal. *Rex v. Kysant*, (1932) 1 K.B. 442. Three accountants testified on Moreland's behalf that they would have certified the statements in the same form as he. *RICH*, at 108. The court clearly distinguished between his civil and criminal responsibilities and noted that Moreland had no motive for the crime. It stated that in certifying the statements Moreland had indicated his own satisfaction with their substantial accuracy and that:

[I]f he was right in that . . . there [should be] an end of the case against him, and he [should be found] not guilty. If on the other hand he was wrong in this sense, [civil liability ought not be imposed upon him for his breach of duty to the company]. . . . But . . . we are not concerned here with any question of civil liability or breach of duty. What you have to determine is whether, assuming that Lord Kysant was guilty . . . , there was any deliberate and conscious act on the part of Mr. Moreland in carrying out that design by putting his hand to a certificate which he knew was not justified by the facts and he knew did not correspond with his duty.

RICH, at 107. Moreland was acquitted. *RICH*, at 108.

4. *E.g.*, in tax practice the accountant subjects himself to perjury prosecution, *INT. REV. CODE OF 1954*, § 7206(1), by wilfully preparing a false tax return, *Levin v. United States*, 5 F.2d 598 (9th Cir.), *cert. denied*, 269 U.S. 562 (1925), and to tax evasion prosecution, *INT. REV. CODE OF 1954*, § 7206(2), by wilfully assisting others to evade their taxes, *United States v. Borgis*, 182 F.2d 274 (7th Cir. 1950). *See United States v. Edwards*, 230 F. Supp. 881 (D.C. Ore. 1964), *rev'd in part on other grounds*, 375 F.2d 862 (9th Cir. 1967).

5. 18 U.S.C. § 1001 (1964).

6. 18 U.S.C. § 1341 (1964).

7. 18 U.S.C. § 2 (1964).

8. 18 U.S.C. § 371 (1964).

9. Securities Act of 1933 § 24, 15 U.S.C. § 77x (1964) [Hereinafter cited as Securities Act].

10. Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff (1964) [Hereinafter cited as Exchange Act].

A. *The Mens Rea Problem*

Before beginning an analysis of the individual statutes, one common problem should be noted. All of the statutes require *mens rea* on the part of the defendant. The false statement statute and the criminal provisions of both the Securities Act and Exchange Act require "wilful" violation. Part (b) of the aiding and abetting statute applies to those who "wilfully" cause an act to be done which violates a federal statute. The mail fraud statute requires that the defendant have an "intent to defraud." The conspiracy statute has been judicially interpreted as requiring an "intent to injure or defraud."

Classically, "wilfulness" demands that the prohibited act be done consciously or intentionally as opposed to accidentally.¹¹ This definition, in large measure, has been sustained by commentators who define the "wilful" requirement in terms of advertence to surrounding circumstances and consequences.¹² This means that if the statute requires wilful activity, the defendant must advert to the elements which make his activity a crime.¹³ Since this demands that the defendant be "conscious" of his actions, the commentators have suggested that the accused must act either recklessly or knowingly.¹⁴ Negligence, by definition, assumes inadvertence.¹⁵ Under this classic approach, then, one can be convicted for intentional or reckless actions, but not for negligent violations.

Legislatures are notoriously sloppy in their drafting of criminal statutes.¹⁶ Though "wilfulness" is generally added to a statute to indicate some form of *mens rea* is necessary, the legislatures seldom define exactly to what elements of the crime the requirement applies.

11 See e.g., *United States v. Illinois Cent. R.R.*, 303 U.S. 239, 242-43 (1937); *United States v. Murdock*, 290 U.S. 389, 393-94 (1933); *United States v. Rabinowitz*, 327 F.2d 62, 77-80 (6th Cir. 1964); *Garrett v. Commonwealth*, 215 Ky. 484, 487, 285 S.W. 203, 204 (1926).

12 G. WILLIAMS, *CRIMINAL LAW, THE GENERAL PART* 34, 35 (2d ed. 1961) (Hereinafter cited as WILLIAMS); Remington & Helstad, *The Mental Element in Crime—A Legislative Problem*, 1952 WISC. L. REV. 644, 663 [Hereinafter cited as Remington].

13 WILLIAMS, at 34.

14 WILLIAMS at 31; Remington at 658.

15 Williams says that.

Outside the class of crimes requiring *mens rea* there are some that do not require any particular state of mind but do require negligence. Negligence in law is not necessarily a state of mind, and thus these crimes are best regarded as not requiring *mens rea*. However, negligence is a kind of legal fault, and in that respect they are akin to crimes requiring *mens rea*.

WILLIAMS at 31.

16 Remington at 644.

For example, if a statute prohibits the wilful filing of false statements, one can legitimately ask whether the "wilful" applies only to the filing or if one is required to advert to the falsity of the statement.¹⁷

The courts, then, have been forced to interpret the meaning of wilfulness according to the purpose of the individual statute.¹⁸ As courts differ over the purpose of a statute, they appear to differ over the requirement of wilfulness.¹⁹ For the accountant, the problems created by this *ad hoc* determination of the courts are compounded by the nature of their profession.

The accountant is most vulnerable to federal prosecution when he is fulfilling his auditing functions. These activities are governed within the profession by standards promulgated by the American Institute of Certified Public Accountants, and ultimately by the standards embodied in the regulatory laws themselves. Good faith compliance with these standards should insulate an accountant from criminal liability for he cannot act recklessly or intentionally and still act in good faith.²⁰ But since it is a state of mind, good faith can only be proven inferentially.²¹ Professional men who conform to the standards of their profession are presumed to act in good faith.²² The auditor who

17. Thus, the Model Penal Code specifies which elements of a crime the specified *mens rea* will apply to. MODEL PENAL CODE, § 2.02 (1962).

18. United States v. Murdock, 290 U.S. 389, 395-96 (1933).

19. For example, the circuits are in conflict over the ability of the government to secure conviction for "wilful" failure to file a tax return if the defendant's actions were in careless disregard to his duty. Compare Abdul v. United States, 254 F.2d 292 (9th Cir. 1969); Yarbrough v. United States, 230 F.2d 56 (4th Cir. 1956), with United States v. Vitiello, 363 F.2d 240 (3d Cir. 1966); Haner v. United States, 315 F.2d 792 (5th Cir. 1963). See also the discussion in United States v. Benjamin, 328 F.2d 854 (2d Cir. 1964) considering the degree of scienter a defendant must have to be held wilfully to have violated the Securities Act.

20. E.g., Beck v. United States, 305 F.2d 595, 599 (10th Cir.), cert. denied, 371 U.S. 890 (1962); Harris v. United States, 261 F.2d 792, 796 (9th Cir. 1958), cert. denied, 360 U.S. 933 (1959); Gold v. United States, 36 F.2d 16, 32 (8th Cir. 1929). See generally Durland v. United States, 161 U.S. 306, 314 (1968); United States v. Baren, 305 F.2d 527, 533 (2d Cir. 1962). For a case in which good faith was an unsuccessful defense to the charge of conspiracy, see Walters v. United States, 256 F.2d 840, 843 (9th Cir.), cert. denied, 358 U.S. 833 (1958).

21. Walters v. United States, 256 F.2d 840, 841 (9th Cir.), cert. denied, 358 U.S. 833 (1958); United States v. Brandt, 196 F.2d 653, 657 (2d Cir. 1952); Deaver v. United States, 155 F.2d 740, 744-45 (D.C. Cir.), cert. denied, 329 U.S. 766 (1946); Marshall v. United States, 146 F.2d 620 (9th Cir. 1944).

22. Ayers v. Parry, 192 F.2d 181, 184 (3d Cir. 1951), cert. denied, 343 U.S. 980 (1952); see Hayward v. Echols, 362 F.2d 791, 796-97 (5th Cir. 1966); Nardini v. Gilbert, 260 F.2d 177 (4th Cir. 1958); Spangler v. Sellers, 5 F. 882, 887 (C.C.S.D. Ohio 1881); Gammel v. Ernst & Ernst, 245 Minn. 249, 253, 72 N.W.2d 364, 367 (1955); Pike v. Honsinger, 155 N.Y. 201, 209, 49 N.E. 760, 762 (1898). See also Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 703 (S.D.N.Y. 1968). See generally 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 17.3 (1956); VII J.

satisfies generally accepted auditing standards in the performance of his examination and the expression of his opinion,²³ and the accountant who conforms to generally accepted accounting principles, act in good faith and should incur no criminal liability.²⁴

But in a field as quickly changing as securities law, and since an accountant's task is highly dependent on the demands of his client, these standards cannot be expected to govern explicitly every knotty or unique problem. It is in this gray area that the courts have the most difficulty.²⁵ They must distinguish between a good faith effort to comply with accounting standards and a "wilful" violation of the statutes. Since both the accounting standards and the definition of "wilful" are vague, there is a danger that "wilful" may be expanded to include what would otherwise be considered negligent activities.²⁶

WIGMORE, THE LAW OF EVIDENCE § 2090 (3d ed. 1940); McCoid, *The Care Required of Medical Practitioners*, 12 VAND. L. REV. 549, 614 (1959).

When there is no definitive standard of conduct or action concerning a question, the professional man need only exercise his honest judgment. *St. George v. State*, 283 App. Div. 245, 251, 127 N.Y.S.2d 147, 150 *aff'd*, 308 N.Y. 681, 124 N.E.2d 320 (1954); *Kinsley v. Curravetta*, 244 App. Div. 213, 219, 279 N.Y.S. 29, 32-33 (1935), *aff'd*, 273 N.Y. 559, 7 N.E.2d 691 (1937); *People v. Kressel*, 243 App. Div. 137, 149, 277 N.Y.S. 168, 175 (1935); *Hodges v. Carter*, 239 N.C. 517, 521, 80 S.E.2d 144, 146 (1954); *Collins v. Wanner*, 382 P.2d 105, 109 (Okla. 1963).

23. Pre-Trial Memorandum for Defendants, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June, 1968) *appeal docketed*, No. 32828-30 (2d Cir. 1968). It has been stated recently that "accountants should not be held to a standard higher than that recognized in their profession." *Escott v. BarChris Constr. Co.*, 283 F. Supp. 643, 703 (S.D.N.Y. 1968); *see Gamel v. Ernst & Ernst*, 245 Minn. 249, 253, 72 N.W.2d 364, 367 (1955).

24. *See Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 703 (S.D.N.Y. 1968); *cf. Hayward v. Echols*, 362 F.2d 791, 796-97 (5th Cir. 1966); *Ayers v. Parry*, 192 F.2d 181, 184 (3d Cir. 1951), *cert. denied*, 343 U.S. 980 (1952); *Spangler v. Sellers*, 5 F. 882, 887 (C.C.S.D. Ohio 1881); *Gamel v. Ernst & Ernst*, 245 Minn. 249, 253, 72 N.W.2d 364, 367 (1955); *Pike v. Honsinger*, 155 N.Y. 201, 209, 49 N.E. 760, 762 (1898). It is possible, of course, that the auditor or accountant may comply with the letter of the standards applicable to him, while knowing that his compliance will foster deceit. If this is the case the defense of good faith is unavailable, but the accountant or auditor would have acted with specific intent to violate the law.

25. Remington recognizes this as a general problem in statutes requiring mens rea. He points out that

Apart from a few jurisdictions, it is generally agreed that something more than ordinary negligence is required as a basis for criminal liability. Having rejected the familiar, if not easy, standard of ordinary negligence, the courts faced the problem of whether to withdraw to the next clear benchmark and require recklessness which, as here used, means a subjective realization of the dangerousness of the conduct. The failure, for the most part, to do so leaves the task of formulating a standard which is neither entirely a subjective test nor the objective test of ordinary care. Conceptually this is as difficult as any problem in the criminal law.

Remington, 658

26. *See United States v. Schaefer*, 299 F.2d 625, 628-31 (7th Cir.), *cert. denied*, 370 U.S. 917 (1962); *Stone v. United States*, 113 F.2d 70, 75 (6th Cir. 1940).

The problem is most evident in the mistake of fact situation. If "wilfulness" is defined in terms of intentional violation, and intentional is given its traditional meaning, then mistake of fact should be a defense to prosecution.²⁷ Such an analysis, however, may not be in accord with the desires of the courts to use the criminal penalty provisions to foster compliance with the provisions of the Securities Acts. Thus, despite the requirement of wilfulness, the courts create a criminal sanction for lack of "due care."²⁸

The way the courts have resolved, or failed to resolve, the *mens rea* problem will be discussed in the context of each of the statutes.

B. False Statements or Entries

1. Actus Rea

Section 1001, the false statements statute, prohibits the knowing and wilful falsifying, concealing, or covering up of a material fact relating to any matter within the jurisdiction of a United States department or agency; making of false or fraudulent statements or representations to such agency; and making or use of a false or fraudulent writing or document knowing it to contain any false, fictitious or fraudulent statement or entry.²⁹ It was enacted to protect "the authorized functions of governmental departments and agencies from the perversion which might result from the deceptive practices described."³⁰

The statute literally requires proof of materiality for conviction only under the first provision, but the weight of judicial authority requires such proof for conviction under the second and third.³¹ Though the

27. WILLIAMS, at 141.

28. Thus, in *Stone v. United States*, 113 F.2d 70, 75 (6th Cir. 1940) the court stated that ignorance would be a defense "unless his ignorance resulted from failure to exercise such discretion as would be expected of a reasonably prudent person."

29. 18 U.S.C. § 1001 (1964).

30. *United States v. Gilliland*, 312 U.S. 86, 93 (1941); *see United States v. Quirk*, 167 F. Supp. 462, 464 (E.D. Pa. 1958).

31. *Gonzales v. United States*, 286 F.2d 118, 120 (10th Cir. 1960); *Freidus v. United States*, 223 F.2d 598, 602 (D.C. Cir. 1955); *Rolland v. United States*, 200 F.2d 678, 679 (5th Cir.), *cert. denied*, 345 U.S. 964 (1953). *Contra*, *United States v. Varano*, 113 F. Supp. 867 (M.D. Pa. 1953).

One basis for this view is that materiality is required under the perjury statute, 18 U.S.C. § 1621 (1964), and section 1001 is so closely related that materiality is required there also. *See, e.g., United States v. Hendrickson*, 200 F.2d 137, 139 (7th Cir. 1952), *cert. denied*, 345 U.S. 926 (1953). Another is that such a highly penal statute must be so interpreted. *See Freidus v. United States*, 223 F.2d 598, 601 (D.C. Cir. 1955). The Second Circuit disagrees and reads the materiality requirement as only applying to the first clause. *United States v. Mahler*, 363 F.2d 673, 678 (2d Cir. 1966); *United States v. Morchisio*, 344 F.2d 653, 666 (2d Cir. 1965). *See also McBride v. United States*, 225 F.2d 249, 253-55 (5th Cir.), *cert. denied*, 350 U.S. 934 (1955).

courts differ somewhat in articulating a standard to define what is "material," the test can be generally stated as whether the false statement "has a natural tendency to influence, or was capable of influencing, the decision of the tribunal in making a determination required to be made."³²

It makes no difference whether the agency acts or plans to act on the statement submitted. The question is whether the statement is calculated to induce reliance by the federal agency.³³ The mere presence of the accountant's audit report and his name is calculated to, and does, induce reliance upon a company's financial statement when submitted to a government agency.³⁴ The Securities Exchange Commission is a government agency within the ambit of the Act,³⁵ and as the preceding discussion of reliance indicates, the fact that the Commission neither approves nor recommends securities after such statements have been submitted to it³⁶ does not exempt the accountant from possible liability. The false representations need only be submitted to a governmental department or agency having the power or authority to act in response to such statements.³⁷ Concentrating on the SEC, since it is primarily with that agency that accountants are involved, the next question is for what sort of false statements the accountant may be held responsible?

The accountant most frequently comes into contact with the Securities Exchange Commission while he is preparing and submitting an audit report. In auditing a client's books, the auditor examines the financial statements of his client and expresses an opinion on the fairness with which they present his financial position and the results

32 *Weinstock v. United States*, 231 F.2d 699, 701 (D.C. Cir. 1956). See *Freidus v. United States*, 223 F.2d 598 (D.C. Cir. 1955) ("could affect or influence"); accord, *Brandow v. United States*, 268 F.2d 559 (9th Cir. 1959).

33 *Brandow v. United States*, 268 F.2d 559, 565 (9th Cir. 1959); *United States v. Allen*, 193 F. Supp. 954, 957 (S.D. Cal. 1961). Because it is the statement's intrinsic capacity which is the criterion for conviction, it is irrelevant that the deception was not practiced to gain a pecuniary advantage. *United States v. Meyer*, 140 F.2d 652, 655 (2d Cir. 1944).

34 See *In re Touche, Niven, Bailey & Smart*, 37 S.E.C. 629, 670-71 (1957); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENTS ON AUDITING PROCEDURE No. 33, at 20 (1963) [hereinafter cited as STATEMENT 33]; L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 22-23 (2d ed. 1965) [hereinafter cited as RAPPAPORT].

35 *United States v. Mahler*, 363 F.2d 673 (2d Cir. 1966).

36 Securities Act § 23, 15 U.S.C. § 77w (1964); Exchange Act § 26, 15 U.S.C. § 78z (1964).

37 See *Ogden v. United States*, 303 F.2d 724 (9th Cir. 1962), cert. denied, 376 U.S. 973 (1964); *Brandow v. United States*, 268 F.2d 559 (9th Cir. 1959).

of operations.³⁸ If he follows generally accepted auditing standards (those which govern the procedure and evaluation of the client's records), he should also state whether the client's books are kept in accord with generally accepted accounting principles.³⁹

In preparing this statement, it is the view of both the accounting profession⁴⁰ and the Securities Exchange Commission⁴¹ that the financial statements on which the accountant reports are not his work product but that of management. In those instances in which an accountant himself prepares the financial statements or special purpose reports from accounts prepared by him or from figures which he fabricates, prosecution would be clear cut.⁴² Normally, however, the only factual representations made by the auditor are those specifically contained in his report.⁴³ These are contained in the scope paragraph and the opinion paragraph.

In the scope paragraph, the accountant states, as a fact, that he has (1) examined the financial statements submitted to him by management, and (2) that his examination was made in accordance with generally accepted auditing standards and that it accordingly included such tests of the accounting records and such other auditing procedures as he considered necessary in the circumstances.⁴⁴

Except for problems of proof, it should not be difficult to test the first representation since one can objectively determine whether the financial statements actually have been examined. As to the second

38. STATEMENT 33.

39. *Id.*

40. *Id.* at 9-10.

41. The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by employment of independent public accountants, however reputable. Accountant's certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting.

In re Interstate Hosiery Mills, Inc., 4 S.E.C. 706, 721 (1939); *In re Breeze Corp., Inc.*, 3 S.E.C. 709, 729 (1938). See also Social Sec. Admin. Bd. *Fed. Cred. Union v. United States*, 138 F. Supp. 639, 657-58 (D. Md. 1956).

42. Since the defendant in *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964) did not submit the fallacious statements to a federal agency, he could not be convicted under 1001. However, the pro-forma statement of combined profit and loss, which he prepared, was described as reflecting the combined earnings of various corporations which had been recently acquired by his client. *Id.* at 860. In truth the acquisition had not been made, and the defendant accountant was or should have been aware of this fact. Thus, had the statements been submitted to a federal agency, he could have been convicted under 1001.

43. STATEMENT 33 at 10.

44. *Id.* at 57; see S.E.C. RULE 2.02, 17 C.F.R. § 210.2-02(b) (1968).

representation, while there is not always unanimity as to which accounting principles are generally accepted,⁴⁵ generally accepted auditing standards are as definitive as most standards of conduct.

For example, the American Institute of Certified Public Accountants' standards require that the auditor use "due care" in his audit.⁴⁶ This is equivalent to saying the auditor must not be negligent in his duties. The courts have had ample experience in determining the fact of negligence. However, the requirement that violations be wilful creates special problems if criminal action is brought for submitting statements which have been negligently compiled. Discussion of these will be postponed until the general discussion of *mens rea*.

Generally accepted auditing standards also require that there be a clear indication of the scope of the auditor's examination, if any, and the degree of responsibility he intends to assume in all cases in which an auditor's name is associated with financial statements.⁴⁷ When certain auditing procedures have been restricted or totally omitted, the accountant must clearly state this fact in a qualification to the scope paragraph of his audit report.⁴⁸ Here, questions of compliance are no more than questions of proof.

In the opinion paragraph, the accountant states that in his opinion the statements which he has examined fairly reflect the financial condition of the company as of the balance sheet date and the results of its operations for the period then ended. Further, he represents that these operations are reflected in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding period.⁴⁹ The accountant who expresses such an unqualified opinion makes another factual representation in his audit report: that his state of mind is such that he truly holds the belief which he has expressed.⁵⁰ When financial statements are presented in a manner which conflicts with generally accepted accounting principles such an unqualified opinion would constitute a violation of Section 1001. His statement that in his "opinion" generally accepted accounting

⁴⁵ See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH AND TERMINOLOGY BULL. 9 (Final ed. 1961).

⁴⁶ STATEMENT 33 at 22.

⁴⁷ *Id.* at 16.

⁴⁸ *Id.* at 15-16.

⁴⁹ *Id.* at 57, see 17 C.F.R. § 210.2-02(c) (1968).

⁵⁰ See Pre-Trial Memorandum for Defendants at 11, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June, 1968) appeal docketed, No. 32828-30 (2d Cir. 1968); cf. *In re Commonwealth Bond Corp.*, 1 S.E.C. 13, 24 (1934).

principles have been followed is a false representation and only the element of wilfulness need be added to complete the crime.

For example, generally accepted auditing standards require the disclosure of certain events which occur after the statement date. Subsequent to the balance sheet date but prior to the issuance of his report, the auditor may learn of an event directly and materially affecting the financial statements to which his report relates—receivables may have been collected or liabilities determined or settled on a basis substantially different from that previously anticipated. Generally accepted standards require that such information be disclosed in the statements⁵¹ and that if not disclosed, the auditor qualify his audit report.⁵²

2. *Mens Rea*

Section 1001 is a catch-all statute and has been applied in situations dealing with registration of narcotics,⁵³ false tax forms,⁵⁴ false registration of firearms⁵⁵ and false home loan applications.⁵⁶ Only infrequently have accountants been charged with its violation. The variety of circumstances in which the statute is applied invites confusion over what sort of mental element is required and such confusion is evident.

The weight of judicial authority holds that the defendant need not

51. STATEMENT 33 at 76.

52. *Id.* at 69. Other events may also occur after the statement date—the company may sign a restrictive covenant in connection with a loan agreement, or may acquire another business—which may affect the company's future flexibility and would be of some concern to the astute investor, but which are not required to be disclosed. *Id.* at 76. Because professional standards do not require such disclosure, it may be unreasonable for the users of financial statements to expect it, regardless of how useful it might be. See Brief for AICPA as *Amicus Curiae* at 26-27, *United States v. Simon*, Docket Nos. 32828-30 (2d Cir. filed 1968). In *Simon*, the certifying accountants were charged with conspiracy to violate the false statements statute. The government contended that it was criminal not to disclose a substantial increase, subsequent to the statement date, in a receivable due from an affiliated company. Pre-Trial Memorandum for Prosecution at 3, 11-14, Pre-Trial Memorandum for Defendants at 47, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June 1968), presently on appeal to the second circuit, Docket Nos. 32828-30. If generally accepted auditing standards are taken as the norm, such a charge was improper; since the post balance sheet accretion in a receivable has no direct effect upon that asset as of the earlier date, disclosure is not required. Nor is it necessary for the auditor to qualify his report because of management's failure to disclose this fact.

53. *McBride v. United States*, 225 F.2d 249 (5th Cir. 1955).

54. *Neely v. United States*, 300 F.2d 67 (9th Cir. 1962).

55. *United States v. Weiler*, 385 F.2d 63 (3d Cir. 1967).

56. *Corcoran v. United States*, 229 F.2d 295 (5th Cir. 1956).

have an evil purpose in order to have “wilfully” violated the statute.⁵⁷ The courts applying this standard follow *McBrinde v. United States*.⁵⁸ In *McBrinde*, a doctor was charged with wilfully filing false statements listing patients to whom he sold narcotics. In this instance, he listed one patient under a false name. He maintained that he had no evil motive and that he was protecting the patient, who was a sheriff, from community disapproval. The doctor contested the instruction given by the trial court that to prove wilfulness the government need only prove that the forbidden act be done “deliberately and with knowledge” and not that the defendant have an “evil intent.” The Fifth Circuit affirmed on the basis of this instruction and differentiated the requirement of wilfulness contained in the false statement statute from that found in other statutes.⁵⁹ The court held that precedents in which other courts had defined wilfulness in the context of other statutes as requiring bad or evil purpose were not in point.⁶⁰

It follows, then, that mistake of law, at least in one sense, would not be a defense to prosecution for violation of Section 1001. If the defendant mistakes the law as to what is false or what is generally accepted as an auditing or accounting standard, his mistake may be merely negligent and a bona fide defense may be possible. However, since he need not have an evil purpose and need only submit his statement deliberately and with knowledge that it is false, it makes no difference whether the individual knows that the submitting of false statements is prohibited. In this situation, at least, mistake of law would be no defense.

Not all courts, however, are willing to accept that no evil purpose is required for a violation of the false statements statute. In *United States v. Weiler*,⁶¹ the Third Circuit called attention to the fact that “wilfulness . . . requires proof of an evil motive.”⁶² In *United States*

57 *Hirsch v. Immigration and Naturalization Service*, 308 F.2d 562 (9th Cir. 1962); *McBride v. United States*, 225 F.2d 249 (5th Cir. 1955); *Walker v. United States*, 192 F.2d 47 (10th Cir. 1951).

58. 225 F.2d 249 (5th Cir. 1955).

59 *Id.* at 254.

60 *Id.* at 254, citing *Townsend v. United States*, 95 F.2d 352, 358 (D.C. Cir. 1938).

61 385 F.2d 63 (3d Cir. 1967).

62 Defendant had submitted an application under the Federal firearms act. One of the questions on the application was whether he had been convicted for any crime that was punishable for over one year. He had been convicted of assault and battery, but paroled for two years. He maintained that he was mistaken in the interpretation of the statute under which he had been convicted. The court held that this was no defense. They rejected the argument that “there cannot be a conviction for making a wilfully false statement when the statement made in the answer

v. Buckley,⁶³ the district court analyzed the need for evil purpose in light of the kind of instrument that was being filed and the need for absolute prohibition of false submission. The defendant in *Buckley* was accused of warranting in a contract filed with the government that no one involved in the procurement of the contract had received a commission, percentage or contingent fee, as payment for such procurement. The court could have found that such a person had been involved in procuring the contract, but, because the defendant had no evil purpose,⁶⁴ and because the transaction was not that which was really aimed at by the warranty clause, the court dismissed the action.⁶⁵

In one Tenth Circuit case, the court cut through all of the questions about *mens rea* and stated that "[A]ll the government was required to do was to prove that the record was false. To illustrate: If the government proved that appellant purchased 50,000 grains of morphine and that his dispensation record showed that he had dispensed only 20,000 grains, it would have proved its case."⁶⁶

As can be seen from the foregoing discussion, most of the courts require that the defendant know the statement to be false, though at least one case contains dictum that would dispense with this requirement. This means that either reckless or intentional falsification would suffice for confiscation. If the accountant or auditor is negligent in either carrying on his activities or in ascertaining the standards he represents that he is following, his actions, though morally reprehensible, should not suffice for conviction under the false statements statute. However, in some jurisdictions, *i.e.*, those which would follow the Tenth Circuit rationale expressed in their hypothetical above, all that would need to be shown is that the accountant did not do as he represented. It is submitted that this rationale is unacceptable. Though his actions in filing the statements are wilful in the sense that he knows what he is physically doing, he has in no way adverted to

requires expert or special knowledge on the part of the answerer." *Id.* at 65. The court admitted that there may be situations where such a rule would be applicable, but stated that in this case the applicant had requested agency action. To have the agency act he was required to make a representation. "He cannot, at least as a matter of law, be relieved of the consequences of a material misrepresentation when the means of ascertaining the truthfulness of his statement were available." *Id.* at 65. This seems in conflict with the recognition of a requirement for an evil motive. *Id.* at 67.

63. 49 F. Supp. 993 (D.D.C. 1943).

64. *Id.* at 994.

65. *Id.* at 995.

66. *Mitchell v. United States*, 143 F.2d 953, 956 (10th Cir. 1944).

the falsity of the statements. His liability, if any, would be civil rather than criminal.

C. Mail Fraud

1. *Actus Rea*

The purpose of the mail fraud statute⁶⁷ is to prevent the mails from being associated with or used in any wilful scheme or artifice to defraud.⁶⁸ It requires proof of two elements: the devising of a scheme or artifice to defraud or obtain money by false pretenses and the use in some manner of the mails to transmit a false document in furtherance of the scheme.⁶⁹

Artifice and scheme mean much the same thing: a devious, contriving, disingenuous, subtle, deceptive, cunning and tricky plan, act or method.⁷⁰ The scheme need not be one which will be successful when completed;⁷¹ any scheme reasonably calculated to defraud a person of ordinary comprehension is within the statute.⁷² Factual misrepresentations are not necessary,⁷³ though they are also within the statute, and wilful non-disclosure of certain facts may likewise subject a person to prosecution.⁷⁴

Actual reliance by the intended victim is not necessary for conviction⁷⁵ nor is it relevant whether the perpetrator expects to or does receive a benefit, pecuniary or otherwise, from his scheme.⁷⁶ Therefore,

67 18 U.S.C. § 1341 (1964).

68 *Parr v. United States*, 363 U.S. 370, 389 (1960).

69 *Gold v. United States*, 350 F.2d 953 (8th Cir. 1965); *Beck v. United States*, 305 F.2d 595 (10th Cir.), *cert. denied*, 371 U.S. 890, (1962); *United States v. Shavin*, 287 F.2d 647 (7th Cir. 1961).

70 *Stockton v. United States*, 205 F. 462 (7th Cir. 1913); *Horman v. United States*, 116 F. 350 (6th Cir.), *cert. denied*, 187 U.S. 641 (1902).

71 *Farmer v. United States*, 226 F.2d 219 (4th Cir. 1955); *Baker v. United States*, 115 F.2d 533 (8th Cir.), *cert. denied*, 312 U.S. 692 (1940); *Rimmerman v. United States*, 186 F. 307 (8th Cir. 1911); *Brooks v. United States*, 146 F. 223 (8th Cir. 1906).

72 *E.g.*, *Oesting v. United States*, 234 F. 304 (9th Cir. 1916), *cert. denied*, 242 U.S. 647 (1917); *Rimmerman v. United States*, 186 F. 307 (8th Cir. 1911); *Brooks v. United States*, 146 F. 223 (8th Cir. 1906).

73 *E.g.*, *Silverman v. United States*, 213 F.2d 405 (5th Cir.), *cert. denied*, 348 U.S. 828 (1954); *Henderson v. United States*, 202 F.2d 400 (6th Cir. 1953); *Fournier v. United States*, 58 F.2d 3 (7th Cir. 1932).

74 *Irwin v. United States*, 338 F.2d 770 (9th Cir. 1964), *cert. denied*, 381 U.S. 911 (1965); *United States v. Miller*, 210 F. Supp. 716 (S.D. Tex. 1962).

75 *Admiral v. United States*, 346 F.2d 654 (5th Cir.), *cert. denied*, 382 U.S. 823 (1965); *Blue v. United States*, 138 F.2d 351 (6th Cir. 1943), *cert. denied*, 322 U.S. 736 (1944); *see Erwin v. United States*, 242 F.2d 336 (6th Cir. 1957).

76 *See Calnay v. United States*, 1 F.2d 926 (9th Cir. 1924). *See generally* *Butler v. United States*, 53 F.2d 800 (10th Cir. 1931).

although the accountant receives only his standard fee, he may be held to have violated the mail fraud statute.⁷⁷

There is no need to prove that the defendant had actual knowledge that the mails would be used in connection with the scheme to defraud⁷⁸—a fair inference will suffice.⁷⁹ If a person acts with knowledge that the use of the mails will follow in the ordinary course of business,⁸⁰ or if such use can reasonably be foreseen even though it is not actually intended, he “causes” the mails to be used as contemplated by the statute.⁸¹ Preparing or certifying financial statements or special purpose reports which he knows are false and which he knows will be used by his client to obtain credit,⁸² sell securities,⁸³ or finance a new process⁸⁴ would suffice to charge the accountant with mail fraud. Adding to the accountant’s liability, since each mailing constitutes a separate offense,⁸⁵ each of these transactions would support at least a two count indictment: the mailing to the client and the latter’s mailing to the victim.

2. *Mens Rea*

The mail fraud statute prohibits only artifices to defraud. The courts have said that this means the prosecution must prove an intent to defraud.⁸⁶ The intent need not be proven by direct evidence,⁸⁷ as in the

77. The size of the fee appears to be irrelevant. See *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964).

78. *E.g.*, *United States v. Young*, 232 U.S. 155 (1914).

79. *E.g.*, *United States v. Kenofsky*, 243 U.S. 440 (1917); *Bruce v. United States*, 351 F.2d 318 (5th Cir. 1965); *Marvin v. United States*, 279 F.2d 451 (10th Cir. 1960); *Belvin v. United States*, 273 F.2d 583 (5th Cir. 1960).

80. *Belvin v. United States*, 273 F.2d 583 (5th Cir. 1960).

81. *Marvin v. United States*, 279 F.2d 451 (10th Cir. 1960); *cf. Pereira v. United States*, 347 U.S. 1 (1954).

82. *E.g.*, *United States v. Epstein*, 152 F. Supp. 583 (E.D. Pa. 1957); *United States v. Yorsaner*, 20 F. Supp. 902 (E.D.N.Y. 1937). Interestingly, the court in *United States v. Epstein*, *supra* at 584, speaks of one Segal who was Epstein’s accountant. Segal was asked to prepare financial statements reflecting the financial position of Epstein’s company for the purpose of acquiring credit for it. At Epstein’s direction, Segal typed on his own stationery and signed a letter of transmittal addressed to a particular prospect. Both the letter and a copy of the statement were delivered by Segal to Epstein for mailing. Although the court indicated that Segal knew of certain improprieties contained in his statements and derived from Epstein’s accounts, it made no mention of any criminal action brought against the public accountant.

83. See *United States v. White*, 124 F.2d 181 (2d Cir. 1941); *United States v. Simon*, 66 Crim. 831 (S.D.N.Y., June 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

84. See, *e.g.*, *United States v. Getchell*, 282 F.2d 681 (5th Cir. 1960).

85. *Hanrahan v. United States*, 348 F.2d 363 (D.C. Cir. 1965); *Atkinson v. United States*, 344 F.2d 97 (8th Cir. 1965).

86. *E.g.*, *United States v. Shipp*, 359 F.2d 185 (6th Cir.), *cert. denied*, 385 U.S. 903 (1966);

other crimes requiring a wilful violation, a series of acts innocent in themselves when considered as a whole may provide ample basis to infer the required intent.⁸⁸

*United States v. Benjamin*⁸⁹ illustrates the use of such inferences. In *Benjamin*, the accountant prepared a balance sheet reflecting total assets of \$7.8 million and net worth of \$3.7 million, which he described as an accurate and true presentation of the company's net worth. The following month he went to California to investigate a possible acquisition for his client. The company failed to pay an expense advance which had been promised. The hotel terminated both his food and telephone service for nonpayment of bills. Still, upon his return, he reported total assets of \$8.7 million and a \$0.9 million increase in net worth, and extolled the prospects of the company. The court stated that "... the cumulation of instances, each explicable only by extreme credulity or professional inexpertness, may have a probative force immensely greater than any one of them alone,"⁹⁰ and upheld the defendant's mail fraud conviction.⁹¹

Williams v. United States, 278 F.2d 535, 537 (9th Cir. 1960); *United States v. Kyle*, 257 F.2d 559, 564 (2d Cir. 1958), *cert. denied*, 358 U.S. 937 (1959); *United States v. Corlin*, 44 F. Supp. 940, 943 (S.D. Cal. 1942); *cf. Yusem v. United States*, 8 F.2d 6 (3d Cir. 1925).

⁸⁷ *I.g.*, *Beck v. United States*, 305 F.2d 595 (10th Cir.), *cert. denied*, 371 U.S. 890, 895 (1962); *Nassan v. United States*, 126 F.2d 613 (4th Cir. 1942).

⁸⁸ See *United States v. White*, 124 F.2d 181 (2d Cir. 1941); *accord*, *United States v. Dardi*, 330 F.2d 316, 325 (2d Cir. 1964); *United States v. Valenti*, 134 F.2d 362, 365 (2d Cir.), *cert. denied*, 319 U.S. 761 (1943); *Nassan v. United States*, 126 F.2d 613 (4th Cir. 1942); *Wood v. United States*, 125 F. Supp. 42, 48 (S.D.N.Y. 1954).

⁸⁹ 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964).

⁹⁰ *Id.* at 862 quoting Learned Hand's opinion in *United States v. White*, 124 F.2d 181, 185 (2d Cir. 1941).

⁹¹ Similarly, in *United States v. White*, 124 F.2d 181 (2d Cir. 1941), the accountant, in preparing financial statements, only regurgitated data furnished him by his client and the corporate books. Included among the assets, at 87½% of its face value, was a receivable purchased by the company for less than 25% of such value. Among the notes receivable was a claim for \$8,000 representing services rendered a publishing corporation which had been acquired by the client only the year before at a cost of \$150. The debtor corporation published a magazine having no subscribers, had no assets other than the stock of its purchaser, operated out of the same office, and used the same secretary as the acquiring corporation. The court stated that while some accountants disagreed as to the realization of profits on the mere purchase of assets, the defendant had to be very credulous to believe what was represented to him. *Id.* at 183. The court held, "It is true that all these instances, taken singly, do not prove beyond a question that White knew that the statements he prepared were padded with false entries; but logically the sum is often greater than the aggregate of the parts. . . ." *Id.* at 185.

⁹² *Elbel v. United States*, 364 F.2d 127 (10th Cir. 1966), *cert. denied*, 385 U.S. 1014 (1967); *United States v. Sheiner*, 273 F. Supp. 977, 983 (S.D.N.Y. 1967). In *Slakoff v. United States*, 8 F.2d 9 (3d Cir. 1925), a financial statement was sent through the mails and contained grossly

Even if it is clear the defendant was unaware of the falsity of the statements mailed, courts may infer that he recklessly or deliberately shut his eyes to the obvious.⁹² Both of these situations have been held sufficient for conviction. Some courts have gone even further. In *United States v. Stone*, for example, the court stated that:

[I]gnorance of facts set up as a defense is unavailing where the defendant, by the exercise of due diligence, could have become aware of his mistakes [I]f any particular appellant were [sic] ignorant of facts from the knowledge of which alone, fraudulent intent could be inferred, he cannot be convicted of a violation of the present statutes, unless his ignorance resulted from failure to exercise such discretion in ascertaining the facts as would be expected of a reasonably prudent person.⁹³

This is an extreme position. Normally, good faith is an absolute defense to a prosecution for mail fraud.⁹⁴ Though it is an affirmative defense and must be proven by the defendants,⁹⁵ it should preclude negligence as sufficient *mens rea* for conviction.⁹⁶

The recent *United States v. Simon*,⁹⁷ however, appears to represent a departure from the weight normally given a defense of good faith. The defendants in *Simon* were convicted of mail fraud in connection with their audit and certification of the 1962 financial statements of Continental Vending Machine Corporation. The prosecution charged that, regarding a substantial receivable due Continental from Valley, its major affiliate, the defendants had intentionally drafted a misleading footnote to the statements which had the effect of reducing Continental's exposure to loss on the asset.⁹⁸ Reported among the assets were accounts receivable from Valley in the amount of \$3.5 million and a parenthetical reference to footnote 2.⁹⁹ The current

misrepresented facts. The court held that the defendant was under a duty to make an investigation. He would be subject to the act, if, in failing to make such an investigation he acted with gross negligence.

93. *Stone v. United States*, 113 F.2d 70, 75 (6th Cir. 1940).

94. *Steiger v. United States*, 373 F.2d 133 (10th Cir. 1967); *Beck v. United States*, 305 F.2d 595 (10th Cir.), *cert. denied*, 371 U.S. 890 (1962); *United States v. March*, 251 F. Supp. 642 (M.D. Pa. 1966).

95. *Steiger v. United States*, 373 F.2d 133 (10th Cir. 1967).

96. See notes 20 to 24 *supra*, and accompanying text.

97. *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

98. Trial Memorandum for Prosecution at 14-16, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

99. Continental Vending Machine Corp., Consolidated Balance Sheet, Sept. 30, 1962, reprinted

liabilities included more than \$8.2 million of long term debt due within one year but there was no indication that Valley was among the creditors.¹⁰⁰ Reflected under the classification "long term debt," in addition to parenthetical references to footnotes 2 and 7, was a payable to Valley of approximately \$0.5 million.¹⁰¹ Footnote 7 contained a schedule of long term debt and disclosed a liability to Valley of more than one million dollars.¹⁰² Footnote 2 disclosed that the Valley receivables less the Valley payables were secured by Valley's equity in certain marketable securities, the current value of which exceed the net amount receivable.¹⁰³ Generally accepted accounting principles require

as Appendix A in Pre-Trial Memorandum for Defendants, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

100 *Id*

101 *Id*

102 Footnote 7 read as follows:

The amounts of long-term debt payable during each of the years ending September 30, 1964 through 1967 are as follows:

<i>Year Ending</i>	
1964	\$2,201,055
1965	1,141,039
1966	693,081
1967	373,777
Thereafter	3,462,187
	<u>\$7,871,139</u>

The amounts of long-term debt, including the portion due within one year, on which interest is payable currently or has been discounted in advance, are as follows:

Payable currently:

At 6% a year	9,292,012
At various other rates, principally 12% a year	1,586,049

Discounted in advance, principally at 6% a year:

Valley Commercial Corp., affiliate	1,029,475
Others	4,003,034

Noninterest-bearing	164,357
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\$16,074,927

Approximately \$9,144,000 of these amounts was secured by collateral.

103 Footnote 2 read as follows

The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr Harold Roth is an officer, director and stockholder) bears interest at 12% a year. Such amount, less the balance of the notes payable to that company, is secured by the assignment to the Company of Calley's equity in certain marketable securities. As of February 15, 1963, the amount of such equity at current market quotations exceeded the net amount receivable.

that assets and liabilities regardless of source not be offset unless a right to offset exists.¹⁰⁴ No such right existed in the present situation¹⁰⁵ because the Valley payable represented notes that Continental's subsidiaries, via Continental, had borrowed from Valley which had in turn discounted them with banks. Therefore, Continental's liability (as endorser) on such notes, while contingent,¹⁰⁶ was to third parties, not to Valley, and for that reason could not be offset against the Valley receivables. However, the defendants had secured and acted pursuant to a formal legal opinion of Continental's outside counsel which in effect stated that the current value of the collateral equaled the *gross* amount of Continental's receivables at the balance sheet date.¹⁰⁷ Therefore, by stating that such value adequately secured the *net* amount of the receivables, the accountants were *understating* the existing facts of which they had knowledge at the time. Accountants have a duty to express an expert opinion as to the fairness of financial statements taken as a whole and if any item contained therein makes the presentation of such statements unfair or improper, the accountants are required to appropriately qualify their opinions or to render adverse opinions.¹⁰⁸ While the balance sheet properly reflected the items "broad," footnote 2, in light of other balance sheet figures, conveyed the misleading impression that the two balances could be offset. Even a finding of negligence on this ground must be questioned in light of the circumstances confronting the defendants at the time of their certification. Having been made subjectively aware by the opinion of counsel that the collateral was adequate for the gross amount of the receivable, the defendants could reasonably have concluded that the statements were fair and true in their presentation—that such collateral exceeded the net amount receivable.¹⁰⁹

104. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH AND TERMINOLOGY BULLETIN, ch. 3, § B (final ed. 1961).

105. *Id.*; AMERICAN ACCOUNTING ASSOCIATION, ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL STATEMENTS 17 (1967).

106. U.C.C. § 3-414, *et seq.*

107. See Letter from Arthur N. Field to Lybrand Ross Bros. & Montgomery, Feb. 14, 1963, reprinted in Pre-Trial Memorandum for Defendants at 38-39, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

108. STATEMENT 33 at 56, 58-59 (1963).

109. Independent Auditors may not, with impunity and without further investigation, rely on information supplied by management, *see, e.g.*, *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964); *cf.* *United States v. White*, 124 F.2d 181 (2d Cir. 1941). The auditor's expertise is not in law. *O'Connor v. Ludlam*, 92 F.2d 50, 56 (2d Cir. 1937). Therefore, his good faith reliance upon those whose expertise offers presumptive knowledge is both necessary

The *Simon* case illustrates the common problem running through the statutes, *i.e.*, a failure to properly articulate the standard that will be applied in assessing the necessary mental element of the crime. Since, obviously, the circuits differ in the standards that they do apply, and since a financial statement of a large corporation is sent through the mails to virtually all states, the guilt or innocence of a defendant could well depend on the jurisdiction in which the federal government brings action. A more definitive answer to the necessary *mens rea* is impossible in light of this confusion.

D. Conspiracy

A conspiracy is a combination formed by agreement in order to accomplish some unlawful purpose coupled with some overt act in furtherance of the plan.¹¹⁰ It has been said to involve a deliberate plotting to violate the law,¹¹¹ whose secrecy renders its detection difficult,¹¹² and whose numerous members may make success more likely.¹¹³ The federal conspiracy statute penalizes two types of conspiracy: that to commit any offense against the United States and that to defraud the United States or any of its agencies.¹¹⁴ The first type encompasses mail fraud and the anti-fraud provisions of the securities laws and the second covers conspiracies to submit false statements to a federal department or agency.¹¹⁵

Traditionally, conspiracy requires proof of a specific intent to violate the law.¹¹⁶ The same intent necessary to commit a substantive offense

and is evidence of his good faith. *United States v. Painter*, 314 F.2d 939, 943 (4th Cir.), *cert denied*, 374 U.S. 831 (1963); *United States v. Crosby*, 294 F.2d 928, 942-43 (2d Cir.), *cert. denied*, 368 U.S. 984 (1962), *cf.* *United States v. Danser* 26 F.R.D. 580, 587 (E.D. Mass. 1959), *aff'd*, 281 F.2d 492 (1st Cir. 1960).

110 18 U.S.C. § 371 (1964); *e.g.*, *Hyde v. United States*, 225 U.S. 347, 359 (1912) (conspiracy requires not only an unlawful combination but also an overt act for an indictable offense to occur); *Bannon v. United States*, 156 U.S. 464, 468 (1895) (any one of the conspirators can perform the overt act, which is then imputed to all other co-conspirators); *United States v. Wooton*, 29 F. 702, 703 (E.D.S.C. 1887). *See generally*, R. PERKINS, CRIMINAL LAW, 527-49 (1965).

111 *See e.g.*, *Pinkerton v. United States*, 328 U.S. 640, 644 (1946); *United States v. Rabinowich*, 238 U.S. 78, 88 (1915).

112. *Pinkerton v. United States*, 328 U.S. 640, 644 (1946); *United States v. Rabinowich*, 238 U.S. 78, 88 (1915).

113 *See Pinkerton v. United States*, 328 U.S. 640, 644 (1946); *United States v. Rabinowich*, 238 U.S. 78, 88 (1915). *See generally*, R. PERKINS, CRIMINAL LAW, 535 (1965).

114 18 U.S.C. § 371 (1964).

115 *United States v. Ausmeier*, 152 F.2d 349, 358 (2d Cir. 1945). *See also United States v. Webb*, 359 F.2d 558, 562 (6th Cir. 1966).

116 *E.g.*, *Hyde v. United States*, 225 U.S. 347, 359 (1912); 18 U.S.C. § 371 (1948).

is required for a conspiracy to commit such offense¹¹⁷ and, if such intent is present, the conspiracy is complete and all members are guilty as soon as any member of the combination does any act in furtherance of the plan.¹¹⁸ Both elements may be proven inferentially¹¹⁹ but the Supreme Court has warned that inference may not be piled upon inference in attempts to gain conviction of this crime.¹²⁰ Merely agreeing to the plan, without more, will not constitute the overt act required by the statute¹²¹ and neither association with a known criminal¹²² nor knowledge that something illegal is happening or about to happen will, without more, make one a conspirator.¹²³ Still, the tendency to find guilt by association is strong¹²⁴ and conspiracy has been regarded by many as an arbitrary and highly prejudicial means of law enforcement.¹²⁵ In the context of conspiracy, as well in mail fraud, *Simon* illustrates the problem of inferring *mens rea* from a series of actions in the context of professional responsibility.

In *Simon*,¹²⁶ in addition to mail fraud, the defendants were charged

117. *Ingram v. United States*, 360 U.S. 672 (1959); *Danielson v. United States*, 321 F.2d 441, 445 (9th Cir. 1963); *Hernandez v. United States*, 300 F.2d 114 (9th Cir. 1962); *United States v. Bufalino*, 285 F.2d 408 (2d Cir. 1960). *See also* *Guardalibini v. United States*, 128 F.2d 984 (5th Cir. 1942) (intent to commit the substantive offense is necessary to convict for conspiracy even where such intent is not a necessary element of the substantive offense).

118. *Deli Paoli v. United States*, 352 U.S. 232 (1957); *McClanahan v. United States*, 230 F.2d 919 (5th Cir. 1956); *accord*, *Dye v. State*, 90 Ga. App. 736, 738, 84 S.E.2d 116, 117 (1954).

119. *Direct Sales Co. v. United States*, 319 U.S. 703 (1943); *United States v. Manton*, 107 F.2d 834 (2d Cir.), *cert. denied*, 309 U.S. 664 (1938).

120. *Direct Sales Co. v. United States*, 319 U.S. 703 (1943); *Causey v. United States*, 352 F.2d 203, 207 (5th Cir. 1965).

121. *See* *United States v. Falcone*, 311 U.S. 205 (1940); *United States v. Webb*, 359 F.2d 558 (6th Cir. 1966).

122. *United States v. Falcone*, 311 U.S. 205 (1940); *Causey v. United States*, 352 F.2d 203, 207 (5th Cir. 1965).

123. *United States v. Falcone*, 311 U.S. 205 (1940).

124. *See* *Krulwich v. United States*, 336 U.S. 440, 457 (1949); *United States v. Aussemir*, 152 F.2d 349, 356 (2d Cir. 1945).

125. *United States v. Falcone*, 109 F.2d 579, 581 (2d Cir.), *aff'd*, 311 U.S. 205 (1940); *see* 1925 ATTORNEY GENERAL'S ANNUAL REPORT 5, 6, quoting Taft, C.J., presiding over The Conference of Senior Circuit Judges. *See also* B. CARDOZO, NATURE OF THE JUDICIAL PROCESS 51 (1928).

126. 66 Crim. 831 (S.D.N.Y. 1968). In addition to mail fraud and conspiracy, the government charged criminality on two additional grounds.

First, the indictment charged that the cash position reported in the statements was false in that the balances at two banks were restricted and not drawable on demand. Therefore, rather than having nearly \$300,000 on deposit, under the government's contention, the company was overdrawn. A few days before the end of its fiscal year, the company borrowed \$750,000 from each of two different banks under the usual (for Continental) thirty day term loan arrangement,

with conspiracy to file a false form 10-K report with the Securities Exchange Commission. The defendants had accepted as adequate security for a \$3.5 million receivable from Valley (an affiliate of Continental) its equity in the latter's securities. Eighty per cent of these securities belonged to Roth, the controlling shareholder of both companies, and had not been registered with the Commission and had been previously pledged by him to various financial institutions as security on certain personal loans. In a note to the financial statements, the net amount of the receivable was described as being secured by Valley's equity in "certain marketable securities," the current market of which exceeded the amount secured. The government contended that the defendants had planned and intended to file the report containing financial statements which were materially fraudulent, and charged that the defendants had acted criminally since they had (1) not disclosed that the securities pledged by Valley were those of Continental; (2) falsely stated that the securities were marketable; and (3) fraudulently accepted such securities as collateral when in fact the

both loans being covered by one letter agreement providing that terms of the agreement could not be modified or varied unless done in writing and contained no restrictions on money loaned. The banks' replies to the standard bank confirmation sent by the defendants indicated that the accounts were subject to withdrawal by check, and, while there was apparently some unwritten understanding between Continental and the banks that it would not draw upon the loan proceeds, an officer of one bank testified at the defendant's first trial that the loan proceeds were "cash in every sense of the word. . . ." Moreover, a prosecution witness at that trial agreed that the actual use of the proceeds should determine their proper accounting treatment. They were in fact drawn upon fully, and the judge at the first trial charged the jury that, as a matter of law, such funds were not restricted. *Id.* at 52-54. The government apparently chose not to press this issue at the second trial. See generally, Brief for Prosecution, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

Secondly, the government charged that Valley was a conduit for the transfer of funds from Continental to Roth, and that the Valley receivable should have been reflected as a receivable from Roth. *Id.* at 27. The defendants were not permitted to inspect Valley's books, Brief for Defendants at 31, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968), and since their audit engagement encompassed only Continental and not Valley, it was not their province to determine the use to which a company not under their audit put the funds advanced to it by their client. *Id.* at 32. The only duties the defendants had with regard to the receivable were segregating it in the balance sheet, checking its collectibility, and disclosing its source as being an affiliate. *Id.* at 33. In fact, the defendants did more than their duty required for they disclosed that Roth was in control of both companies and thereby permitted the inference that the transactions were not at arm's length. Moreover, Form 10-K itself requires that the management—not the auditor—disclose on Form 10-K any material direct or indirect transactions to which directors or officers were a party. *Id.* at 50. On the other hand, even the S.E.C.'s accounting regulations do not require the auditor to disclose amounts due indirectly from such persons. See 17 C.F.R. § 210.5-04 (1968); Brief for Defendants at 50, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

"equity" was nothing more than a second lien on the holdings.¹²⁷ However, "[a]ccountants should not be held to a standard higher than that recognized by their profession,"¹²⁸ and there is no requirement of generally accepted auditing principles that an accountant must specifically disclose that an issuer holds its own securities for debts owed to it.¹²⁹ While unregistered "control" stock may not be sold in a public offering,¹³⁰ there is no prohibition against sales of such stock by direct private placement¹³¹ and, considering the large block available in this instance, private placement would be the most likely as well as the most profitable means of ready disposal or marketability.¹³² Furthermore, the fact that at least two large financial institutions felt adequately secured by such securities is strong evidence of their marketability and therefore supports the defendants' treatment of the securities.¹³³ Moreover, as a condition precedent to accepting such

127. Record at 1, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

128. *Escott v. Bar Chris Const. Co.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

129. Brief for Defendants at 46, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

130. See Securities Act §§ 5, 2(11), 15 U.S.C. §§ 77e, 77b(11) (1964). In *S.E.C. v. Guild Films Inc.*, 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960), the court held that pledges of such control shares, who knew when they received the shares as collateral that immediate sale thereof was almost inevitable if they hoped to recover their loans, were likewise subject to the prohibitions of section 5. In dictum, however, the court said that even a bona fide pledgee of such shares would be subject to the registration requirements and it is generally this dictum upon which the prosecution in *Simon* based its assertion that the defendants should have known that Roth's equity in the Valley shares, which he had pledged with the banks, were subject to registration prior to sale and hence not marketable.

For further treatment of the problem raised by *Guild Films*, see I L. LOSS, SECURITIES REGULATION 645-51 (2d ed. 1961) [hereinafter cited as Loss]. See generally *Fox v. Glickman Corp.*, 253 F. Supp. 1005, 1011-12 (S.D.N.Y. 1966).

131. *S.E.C. v. Guild Films Inc.*, 279 F.2d 485, 490 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960); see Securities Act § 4(1), 15 U.S.C. § 77(d)(1) (1964). Nor is an entirely intrastate offering of control stock subject to registration. See Securities Act § 3(a)(1), 15 U.S.C. § 77c(a)(1) (1964). But see R. BAKER & W. CAREY, CASES AND MATERIALS ON CORPORATIONS 464 (3d ed. Supp. 1968).

132. See Brief for Defendants at 44, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June, 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968). See also *Royal Trust Co. v. Equitable Life Assur. Soc'y*, 247 F. 437, 441 (2d Cir. 1917); *Elliot v. Baker*, 194 Mass. 518, 80 N.E. 450 (1907); R. BAKER & W. CAREY, CASES AND MATERIALS ON CORPORATIONS 590 (3d ed. 1959); Note, *Duties of Controlling Shareholders in Transferring Their Shares*, 54 HARV. L. REV. 648 (1941). But see R. BAKER & W. CAREY, CASES AND MATERIALS ON CORPORATIONS 464 (3d ed. Supp. 1968).

133. Brief for Defendants at 44, *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June, 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968); see R. MONTGOMERY, AUDITING 145 (8th ed. 1957). But see *S.E.C. v. Guild Films Inc.*, 279 F.2d 485, 489 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960); J. Sargent, *Pledges and Foreclosure Rights Under the Securities Act of 1933*, 45 VA.

securities as adequate collateral, the defendants had specifically requested a written legal opinion by Continental's counsel that the securities adequately secured the receivables. The letter of counsel stated that the present market value of the collateral was approximately \$3.5 million *over and above all liens*. While it is true that an auditor serves no function if all he does is to rely on what the management and its representatives tell him, it is also true that an accountant's expertise is not in the area of expressing legal conclusions.¹³⁴ The court, however, found the defendants guilty.

In two other cases in which accountants were convicted of conspiracy, both the act and the intent were proven inferentially.¹³⁵ However, the basis for these findings was more substantial than in *Simon*. In both *Benjamin* and *White*, the accountants had violated the standards of their profession at the very least. The client in *United States v. Benjamin*¹³⁶ was undertaking a public offering of securities and Howard, the accountant, although aware of the company's financial difficulties, nevertheless issued a report extolling its prospects. He had previously issued a report in which he falsely represented that he had performed certain auditing work when in reality he had merely lent his name and professional designation to a false statement prepared by the company. The accountant in *United States v. White*¹³⁷ lacked independence. When the president of his client told him that it had a substantial number of large receivables, White sent out confirmations. Upon receiving a negative reply from a major debtor, he confronted the president with this discrepancy but was advised not

L. REV 885 (1959). See generally S.E.C. PROBLEMS OF CONTROLLING SHAREHOLDERS AND TRANSFERS IN UNDERWRITING (Israels ed. 1962).

134. Accountants profess to speak with knowledge when certifying to an agreement between an audit and the entries in the books audited, but there is no suggestion . . . that a statement by an auditor that notes are secured by the provisions of a trust deed is an assertion of knowledge rather than an expression of opinion. To suggest that a title examiner is guilty of fraud if he erroneously certified a title because he had honestly misconceived the legal significance of a provision in a deed would doubtless horrify . . . members of the legal profession. There is no reason to hold accountants to a higher standard when they deal with legal documents.

O'Connor v. Ludlam, 92 F.2d 50, 56 (2d Cir. 1937). See "Functions of the Certified Public Accountant", Address by J.S. Schumann, to Sullivan & Cromwell Staff, New York City, March, 1967, in [1967] HASKINS & SELLS SELECTED PAPERS 185, 196.

135. *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), cert. denied, 377 U.S. 953 (1964); *United States v. White*, 124 F.2d 181 (2d Cir. 1941).

136. 328 F.2d 854 (2d Cir.), cert. denied sub nom., 377 U.S. 953 (1964).

137. 124 F.2d 181 (2d Cir. 1941).

to press the issue for fear of antagonizing the debtor. The defendant investigated no further. When he discovered that the president had "borrowed" substantial amounts from the corporation on numerous occasions, White, at the president's insistence, charged the thefts to the capital account. In addition, the company had purchased a receivable having a face amount of \$74,000 for \$20,000 and then assigned it to a subsidiary for other assets. The assignment agreement provided that the subsidiary was to receive the first \$22,000 of collections, the excess to go to the parent. White, without disclosing the assignment, set up the receivable at a net relizable value of \$13,000, thus including in the books both the receivable and the assets received in the assignment.

A conspiracy charge may be particularly useful when prosecution for one of the other crimes is impossible because the jurisdictional standards are not met.¹³⁸ Furthermore, conspiracy is separate from the substantive offense (it is the illegal combination at which the statute is aimed)¹³⁹ and may be charged where the "error" is uncovered before a substantive crime is committed or has progressed far enough to be considered an attempt. If the substantive crime is committed, the defendant may be convicted of both offenses.¹⁴⁰ At times, the apparently anomalous result may occur that a defendant convicted of conspiracy will be subjected to a greater fine than if he had been convicted of only the completed substantive offense. The defendants in *United States v. Simon* were convicted on two counts of mail fraud and one of conspiracy.¹⁴¹ One of them received a \$7,000 fine: \$1,000 maximum on each of the two mail fraud charges and \$5,000 maximum on the conspiracy count.¹⁴² The anomaly is more apparent than real, since a conspiracy is a crime in and of itself, and one believed by some to be more sinister than the completed offense.¹⁴³

138. See *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June, 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968) (one of the charges was conspiracy to file a false statement with the S.E.C.; prosecution under section 1001 was not possible because the financial statements had not been submitted to the Commissioner).

139. *United States v. Bazzell*, 187 F.2d 878, 884 (7th Cir.), *cert. denied*, 342 U.S. 849 (1951).

140. See, e.g., *United States v. Simon*, 66 Crim. 831 (S.D.N.Y. June, 1968), *appeal docketed*, No. 32828-30 (2d Cir. 1968).

141. *Id.*

142. *Wall St. Journal*, 27 September 1968, at 4, col. 4.

143. See *Pinkerton v. United States*, 328 U.S. 640, 644 (1946); *United States v. Rabinowich*, 238 U.S. 78, 88 (1915).

E. Aiders and Abettors

The purpose of the aider and abettor provisions¹⁴⁴ is to punish those persons who are incompetent to commit certain crimes as principals.¹⁴⁵ The existence of a preconceived agreement is not necessary for the statute to apply¹⁴⁶ but there must be a person who can be found guilty as a principal.¹⁴⁷ If, because of the absence of planning, a person is found innocent of a conspiracy charge, he can still be found guilty under the aider and abettor statute if his assistance takes place simultaneously with the commission of a crime.¹⁴⁸ Though he will be guilty of conspiracy if he agrees to commit a crime and does some overt act,¹⁴⁹ he cannot be an aider and abettor unless a crime is actually committed.¹⁵⁰ As with conspiracy, passive acquiescence in a crime does not make one an aider and abettor.¹⁵¹ Accordingly, under the aiding and abetting provision, no criminal responsibility attaches to a principal for the acts of his agent unless the principal aids, advises or encourages his agent's criminal act.¹⁵² An aider and abettor must act with knowledge that the offense is to be committed¹⁵³ and, if he does so, is deemed to have intended all the natural and probable consequences of the offense.¹⁵⁴

This statute appears to impose no criminal responsibility on the auditor beyond the other provisions of the Criminal Code. All acts performed in preparing his audit report are adequately encompassed by

144. 18 U.S.C. § 2 (1964).

145. *E.g.* United States v. Lester, 363 F.2d 68 (6th Cir.), *cert. denied*, 385 U.S. 1002 (1966); *Swanne Soon Young Pang v. United States*, 209 F.2d 245 (9th Cir. 1953); *United States v. Snyder*, 14 F. 554 (C.C.D. Minn. 1882).

146. *Nye & Nissen v. United States*, 336 U.S. 613, 620 (1949).

147. *Edwards v. United States*, 286 F.2d 691 (5th Cir. 1960); *Karrell v. United States*, 181 F.2d 981 (10th Cir. 1950). *But see Meredith v. United States*, 238 F.2d 535 (4th Cir. 1956); *I.C.C. v. Blue Diamond Products*, 93 F. Supp. 688 (W.D. Iowa 1950), *aff'd*, 192 F.2d 43 (8th Cir. 1951), both holding that it is not necessary that the principal be first convicted.

148. *See Nye & Nissen v. United States*, 336 U.S. 613, 620 (1949).

149. *Hyde v. United States*, 225 U.S. 347, 359 (1912).

150. *United States v. Dennis*, 183 F.2d 201, 209 (2d Cir. 1950), *aff'd*, 341 U.S. 494 (1951).

151. *See United States v. Dellaro*, 99 F.2d 781, 783 (2d Cir. 1938).

152. *E.g.*, in *In re Myers*, S.E.C. Acct. Series Rel. No. 92, CCH Fed. Sec. L. Rep. ¶ 72,114 (1962), the SEC indefinitely suspended an accountant for impropriety. Myers had acted beyond his authority as a partner at a time when the senior partner was not present and no other member or employee knew what he was doing. Because of these circumstances proceedings against the firm were dismissed and its name was ordered stricken from the record. *In re Myers* is discussed in detail *infra*.

153. *United States v. Turnipseed*, 272 F.2d 106 (7th Cir. 1959).

154. *McClanahan v. United States*, 230 F.2d 919 (5th Cir.), *cert. denied*, 352 U.S. 824 (1956).

the statutes discussed earlier. For example, if he knowingly and intentionally certifies to false and fraudulent financial statements which are sent to the Securities Exchange Commission or through the mail to corporate shareholders or prospective investors or sellers, he is subject as a principal to prosecution under Section 1001, false statements, or the mail fraud statute. If he agrees to certify such statements for any of the foregoing purposes but decides at the last moment not to do so, he is subject as a principal to prosecution for conspiracy. If he makes no certification or audit report but merely advises a layman how to prepare such financial statements and how to write an audit report with the intention to have the report used in any fraudulent manner and the layman then destroys the statements and the report without ever having used them, the auditor has not aided and abetted in the commission of any crime but is still subject as a principal to prosecution for conspiracy.

On the other hand, the aider and abettor provisions significantly broaden the auditor's exposure to fine and imprisonment under the securities laws by allowing conviction on multiple grounds. For example, although the auditor as such does not deal in the purchase and sale of securities, he may aid and abet others who are so engaged,¹⁵⁵ and be prosecuted both for mail fraud in his own right, and for using the fraudulent or otherwise illegal purchase and sales of securities under the aider and abettor statutes.

F. Securities Act of 1933

Both the Securities Act and the Exchange Act authorize the Securities Exchange Commission to transmit to the Attorney General evidence of suspected criminal violations and provide that the latter, in his discretion, may initiate criminal proceedings.¹⁵⁶ When the violations of other statutes is indicated, the Commission will notify the appropriate state or federal agency.¹⁵⁷ Prosecutions under the Securities Act are brought pursuant to Section 24.¹⁵⁸

1. Actus Rea

Section 24¹⁵⁹ can be divided into two parts. The first part penalizes

155. See, e.g., *In re William Todd, Inc.*, 32 S.E.C. 537 (1951); *In re Henry P. Rosenfeld*, 30 S.E.C. 941, 944 n. 3 (1950); *In re Richard K. Fudge*, 30 S.E.C. 334, 338 n. 11 (1949).

156. Securities Act § 20(b), 15 U.S.C. § 77t(b) (1964); Exchange Act § 21(e), 15 U.S.C. § 78u(e) (1964).

157. S.E.C. ANN. REPT., 39 (1942).

158. S.E.C. ANN. REP., 131-32 (1964).

159. 15 U.S.C. § 77x (1964).

the wilful making of any untrue statement of material fact or the wilful omission to state any material fact required or necessary to be stated to make such statement not misleading. The prohibited statement or omission must be made in connection with a registration statement filed with the Commission pursuant to Section 5 of the Act.¹⁶⁰ Because of this requirement, the prohibitions of Section 24 are somewhat narrower than the false statement statute¹⁶¹ but the same sort of questions about material, misleading and the meaning of "wilful" arise. Much, then, of what was discussed in the treatment of the false statements statute is relevant here.

So far as the substantive elements are concerned, it need be noted only that a statement is false within the meaning of Section 24 if no proper accounting method would produce such a figure.¹⁶² It is material if it is capable of inducing a purchase of the securities covered by the statement.¹⁶³ Actual reliance, then, is not necessary; it is the potential for deceit that is prohibited.

The second part of Section 24 prohibits the wilful violation of any of the provisions of the Securities Act or the rules or regulations promulgated thereunder.¹⁶⁴ For example, Section 17(a) makes it unlawful for any person in the offer and sale of securities by the use of the mails or any means of interstate commerce to employ and device, scheme or artifice to defraud.¹⁶⁵ It should be noted that Section 17(a) is not limited to false statements contained in a registration statement as is the false statement provision of Section 24, yet Section 24's penal provisions will apply to the wilful violation of Section 17(a).

Auditors, however, are not normally engaged in the offer and sale of securities, a prerequisite for the application of Section 17(a) through Section 24. Presumably, they would incur criminal liability under the aider and abettor statute if, for example, they fraudulently prepared or certified a false statement for inclusion in a brochure advertising securities.¹⁶⁶

The second part of Section 24 also gives the rules and regulations

¹⁶⁰ *Id*

¹⁶¹ 18 U.S.C. § 1001 (1964).

¹⁶² *United States v. Danser*, 26 F.R.D. 580, 586 (D. Mass. 1959), *aff'd*, 281 F.2d 492 (1st Cir. 1960)

¹⁶³ *Id*

¹⁶⁴ 15 U.S.C. § 77x (1964).

¹⁶⁵ 15 U.S.C. § 77q(a) (1964).

¹⁶⁶ *Cf. United States v. Getchell*, 282 F.2d 681 (5th Cir. 1960).

promulgated under the Act the force and effect of the statute itself.¹⁶⁷ Pursuant to statutory authority, the Securities Exchange Commission has promulgated various accounting rules and regulations, most of which are contained in Regulation S-X.¹⁶⁸ This regulation provides that financial statements are required to be certified exclusively by an independent public or certified public accountant.¹⁶⁹ While many civil and disciplinary proceedings have dealt with the auditor's independence,¹⁷⁰ no criminal cases have been found which specifically consider accountant violations of this rule.

2. *Mens Rea*

The best discussions of the "wilfulness" requirement of Section 24 are found in the opinions of the district court and court of appeals in *United States v. Custer Channal Wing Corp.*¹⁷¹ This was a criminal contempt case based on a violation of Section 5 of the Securities Act.¹⁷² Section 5 requires that certain securities be registered with the

167. 15 U.S.C. § 77x (1964).

168. 17 C.F.R. § 210.1-01 (1968).

169. 17 C.F.R. §§ 210.2-01(b), (c) (1968). The only statements filed with the Commission under the Securities Act which need not contain certified financial statements are those of issuers exempt from full registration. Sec. Act Rel. 3600 (1955) and 3783 (1957); CCH FED. SEC. L. REP., ¶ 5889, Regulation E, Schedule A, Item 11. While there are more exceptions to the certification requirement under the Exchange Act, it is still valid to say that most statements filed with the Commission must be certified. Filings by banks, non-title insurers, and non-North American foreign issuers need not contain certified statements. See I Loss, 346. Nor need such statements be included in semi-annual reports filed on Form 9-K, see CCH FED. SEC. L. REP., ¶ 31,051, Form 9-K, Instruction C, or in the annual reports of certain registrants not in the production stage, see CCH FED. SEC. L. REP., ¶ 31,105, Form 10-K, Instruction as to Financial Statements, 8(b), or in filings of certain broker-dealers and stock exchange members, see CCH FED. SEC. L. REP., ¶ 26,982. Finally, the proxy statement of corporations soliciting proxies for a merger or some other organic change must contain certified financial statements only if practicable. CCH FED. SEC. L. REP., ¶ 24,046, Schedule 14A, Item 15(b). These schedules are summarized in I Loss, 346-47.

170. See, e.g., *In re Sports Areas, Inc.*, Sec. Act Rel. 4153 (1959) (relationship of auditor's employee and client); *In re A. Hollander & Sons, Inc.*, 8 S.E.C. 586, 612-17 (1941) (financial interest in client); *In re Interstate Hoisery Mills, Inc.*, 4 S.E.C. 706, 717 (1939) (original work performed by auditor on records he is auditing); *In re Metropolitan Personal Loan Co.*, 2 S.E.C. 803, 813 (1937) (reliance on unverified information); *In re American Terminals and Transit Co.*, 1 S.E.C. 701 (1936) (conscious falsification of facts).

171. 247 F. Supp. 481 (D. Md.), *aff'd*, 376 F.2d 675 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967). See also *United States v. Danser*, 26 F.R.D. 580 (D. Mass. 1959), *aff'd*, 281 F.2d 492 (1st Cir. 1960); *United States v. Sussman*, 37 F. Supp. 294 (E.D. Pa. 1941).

172. 15 U.S.C. § 77e(a) (1964).

Securities Exchange Commission before any attempt is made to sell them to the public. The government had secured an injunction against the defendant prohibiting violation of this provision. He intentionally sold securities which were in fact unregistered and was found to have violated the injunction. He was convicted of contempt.¹⁷³ Contempt, the district court stated, was like Section 24 of the Securities Act, i.e., it required a wilful violation.¹⁷⁴ The court reasoned that the injunction prohibited violation of Section 5 and was therefore equivalent to Section 24 which would also impose criminal liability for the unlawful sale of unregistered securities. It was sufficient for a violation of either, the court held, that the defendant had knowledge of all of the facts which made the securities subject to the registration requirements. Actual knowledge that the securities were required to be registered was unnecessary.¹⁷⁵ The court of appeals affirmed,¹⁷⁶ adopting the same rationale,¹⁷⁷ and cited with approval the language of *United States v. Sussman*.¹⁷⁸ In *Sussman*, the court stated that he did:

. . . not now conceive an element of the crime charged . . . to be actual knowledge that a security was being sold in violation of the law . . . it was sufficient to establish that the defendants willfully and intentionally sold or delivered unregistered securities by use of the mails.¹⁷⁹

As in the discussion of the *mens rea* requirement of the false statement statute, it appears that in prosecution for a violation of Section 24 mistake of law, in the sense of not knowing one's actions are prohibited, is no defense.¹⁸⁰ In *Custer*, then, no "evil purpose" needed to be proven.¹⁸¹

173 *United States v. Custer Channal Wing Corp.*, 247 F. Supp. 481 (D. Md. 1965).

174 *Id.* at 490.

175 *Id.* at 495.

176. 376 F.2d 675 (4th Cir. 1967).

177 *Id.* at 680-81.

178. 37 F. Supp. 294 (E.D. Pa. 1941).

179. *Id.* at 296.

180 This analysis is essentially that of *Custer Channal Wing Corp.* It is supported by *Sussman*, and the other cases (which do not deal with the Securities Act) cited therein. However, it should be noted that the court of appeals also stated that there were findings of fact in the district court sufficient to support a holding that the defendants did know that they were violating the law. 376 F.2d 675, 682-83 (4th Cir. 1967).

181. It is interesting to note that in *United States v. Danser*, 26 F.R.D. 580, 586 (D. Md. 1959), the court instructed the jury that the defendant need have an intent to defraud. The defendant, however, was accused of violating section 17 of the Securities Act, 15 U.S.C. § 77q (1964), and the "intent" to defraud which the court holds necessary is an element of the section.

However, the court of appeals decision in *Custer* makes it relatively clear that one must have knowledge of what one is doing though not of the prohibition itself.¹⁸² The court of appeals points¹⁸³ out that in *United States v. Crosby*,¹⁸⁴ a conviction was overturned because there was no proof that the defendants "knew or should have known" that they were underwriters. In *United States v. Dardi*,¹⁸⁵ decided by the same circuit three years later, the court stated that the question was whether the defendants "knew" that they were selling for a control group. Knowing or reckless conduct, not with regard to securities law, but as to those things that are forbidden by the Securities Act, seem a minimum *mens rea* under the *Custer* rationale.¹⁸⁶

To apply this to the accountant requires analogy. The question is whether an auditor who intentionally certifies a financial statement which is in fact materially false or misleading for inclusion in a registration statement has acted "wilfully" within the meaning of Section 24. His certification is a material fact which signifies that an independent auditor has conducted a professional examination of the corporation's financial statements. If the accountant were not in fact independent or had not in fact conducted such an examination, his representation would be false and within the statute. To this extent the analogy is valid; but, because financial statements are the representations of management, if the auditor has performed his function in accordance with his responsibility and still fails to discover the falsehoods or learn of the omissions, he should not be subject to the statute. In this case he would not know that the statements were false. This knowledge seems required under the *Custer* rationale.

G. Securities Exchange Act of 1934

Section 32(a) is the relevant criminal provision of the Exchange Act.¹⁸⁷ Its false statements provision differs from its counterpart in the Securities Act in two ways. First, it is more extensive, encompassing statements made in any application, report, or document required by

182. 376 F.2d 675, 680 (4th Cir. 1967).

183. *Id.* at 681.

184. 294 F.2d 928 (2d Cir. 1961).

185. 330 F.2d 316 (2d Cir. 1964).

186. This seems even true with regard to the issuance of an injunction. *United States v. Custer Channal Wing Corp.*, 376 F.2d 675, 680-81 (4th Cir. 1967).

187. 15 U.S.C. § 78ff(a) (1964).

the Act or by the rules or regulations promulgated thereunder¹⁸⁸ while the analogous provision in Section 24 applies only to registration statements.¹⁸⁹ Under section 32(a), an accountant would be exposed to potential liability in connection with annual or periodic reports¹⁹⁰ as well as proxy statements and those submitted in connection with tender offers.¹⁹¹ Second, it penalizes only the knowing and wilful *making* of any statement which is false or misleading with regard to any material fact and does not, by its terms, apply to wilful *omissions* of material facts required to be stated as does Section 24.¹⁹² But this seeming discrepancy in potential liability is of no help to the auditor. His representation is that in his opinion the statements are fair. They may be unfair either due to the inclusion of false statements or the omission of essential information. In either case his representation of their fairness is false.

Under the Exchange Act as well as the Securities Act, the Commission's rules and regulations have been given the force and effect of law.¹⁹³ However, the 1934 Act, unlike the 1933 Securities Act, provides that a defendant may not be subjected to imprisonment for violating such rules and regulations if he proves his ignorance of their existence.¹⁹⁴

Rule 10b-5¹⁹⁵ is the broadest of the regulations under the 1934 Act. It proscribes the use by any person of the mails or of any means of interstate commerce, to employ any device, scheme, or artifice to defraud, or to make any false statement of material fact or to omit to state any such fact as is necessary to make the statements which are made not misleading in connection with the purchase or sale of

188 Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1964).

189 15 U.S.C. § 77x (1964).

190 See *United States v. Simon*, 66 Crim. 831 (S.D.N.Y., June, 1968), *appeal docketed*, no. 328-30 (2d Cir. 1968). But see CCH FED. SEC. L. REP., ¶ 31,105, Form 10-K, Instructions as to Financial Statements, 8.

191 See *United States v. Olen*, 183 F. Supp. 212 (S.D.N.Y. 1960). But see CCH FED. SEC. L. REP., ¶ 26,871, Schedule 14A, item 15(b).

192 Compare Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1964), with Securities Act § 24, 15 U.S.C. § 77x (1964).

193 See Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1964). The Commission's rules have survived attacks on their constitutionality. See e.g., *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 831-32 (D. Del. 1951) (17 C.F.R. § 240.10b-5 (1968)); *Charles Hughes & Co., Inc. v. SEC*, 139 F.2d 434, 436 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (Exchange Act § 15(c), 15 U.S.C. § 78o(c)(1) (1964)).

194 Compare Securities Act § 24, 15 U.S.C. § 77x (1964) with Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (1964).

195 17 C.F.R. § 240.10b-5 (1968).

securities.¹⁹⁶ Although application of Rule 10b-5 in a criminal action has been held valid,¹⁹⁷ it has not been used extensively in such context.¹⁹⁸ It should be noted, however, that Rule 10b-5 relates to practices *in connection with the purchase and sale* of securities and is not limited to those occurring *in the offer and sale* of securities as in Section 17(a) of the Securities Act. Accordingly, the accountant may, as a principal, violate this rule *and* thus Section 32(a) without resort to the statutory fiction of the aider and abettor statute. It should also be noted that by its terms, Rule 10b-5 applies to omissions as well as to commissions. Thus, though the basic criminal statute, Section 32, does not apply to omissions, by encompassing the rules set forth in the regulations, omissions of material fact are made grounds for criminal prosecution.

II. FEDERAL ADMINISTRATIVE SANCTIONS

The Securities Exchange Commission is given statutory authority to establish rules and regulations regarding the privilege of appearance and practice before it.¹⁹⁹ Rule 2 deals with appearance before the Commission²⁰⁰ and provides that the Commission may deny such privilege to any person it finds lacking in character or integrity or who has engaged in any unethical or improper professional conduct.²⁰¹ Under the rules, "practice" includes, but is not limited to, the accountant's preparation of any statement, opinion or other paper which is filed with the Commission in any document containing the accountant's consent.²⁰² Such consent is required in all documents filed with a registration statement or report which the accountant has in part prepared or certified.²⁰³

If the Commission intends to sanction an accountant, before making

196. *Id.*

197. See *United States v. Shindler*, 173 F. Supp. 393 (S.D.N.Y. 1959).

198. A. BROMBERG, *SECURITIES LAW, FRAUD* 10-12 (1968). The proxy fraud rule, 14a-9, 17 C.F.R. § 240.14a-9 (1968), has also found its way into criminal prosecutions. See *United States v. Pope*, 189 F. Supp. 12 (S.D.N.Y. 1960); *United States v. Olen*, 183 F. Supp. 212 (S.D.N.Y. 1960). A single false proxy statement can sustain separate counts under both the false statements provision of section 32(a), and its rules violating provision, see *United States v. Pope*, 189 F. Supp. 12 (S.D.N.Y. 1960); III Loss, 1964, because the gravamen of the former is the filing and of the latter, the solicitation. III Loss, 1994.

199. Exchange Act § 23, 15 U.S.C. § 78w (1964).

200. 17 C.F.R. § 201.2 (1968).

201. 17 C.F.R. § 201.2(e) (1968).

202. 17 C.F.R. § 201.2(g) (1968).

203. Securities Act § 7, 15 U.S.C. § 77g (1964).

its findings, it affords him notice and an opportunity to be heard.²⁰⁴ Upon a final determination that disciplinary action is warranted, the Commission suspends the offender, notifies the professional societies of which he is a member and informs the state boards of accountancy of its actions.²⁰⁵ During the proscribed period, his certificate may not be included in any document or amendment filed with the Commission nor may any registration statement containing such certificate become effective.²⁰⁶ In addition, while he is suspended, the accountant may not utilize the advisory and technical services of the Commission and its staff.²⁰⁷ Moreover, there is some doubt as to the efficacy of any document filed with the Commission subsequent to the suspension period which contains the accountant's certificate dated during the proscribed period.²⁰⁸ Finally, in many jurisdictions, such disciplinary action may constitute adequate grounds for suspension or revocation of the offender's certificate and license to practice. These sanctions also affect the auditor's clients who are subject to the Acts' filing and reporting requirements.²⁰⁹ They may as a result be forced to transfer their business to other accountants.

Most disciplinary hearings are private.²¹⁰ The Commission makes them public only when it deems them to be of sufficient public interest.²¹¹ The Commission has said that these proceedings are rare;²¹²

²⁰⁴ Securities Act § 20, 15 U.S.C. § 77t (1964).

²⁰⁵ RAPPAPORT 23-9.

²⁰⁶ *Id.* 22-13.

²⁰⁷ *Id.* 24-14.

²⁰⁸ *Id.*

²⁰⁹ See RAPPAPORT 22-14.

²¹⁰ S.E.C. Acct. Series Rel. No. 81, CCH FED. SEC. L. REP. ¶ 72,103 (1958); see 17 C.F.R. §§ 203.3, 203.5 (1968); RAPPAPORT 23-8.

²¹¹ *Cf.* S.E.C. Acct. Series Rel. No. 81, CCH FED. SEC. L. REP. ¶ 72,103 (1958).

²¹² *Id.* See RAPPAPORT 23-9. Only 20 of these cases have been made public. *In re* Weiner, S.E.C. Acct. Series Rel. No. 110, CCH FED. SEC. L. REP. ¶ 72,132 (1968); *In re* Aronowitz, S.E.C. Acct. Series Rel. No. 109, CCH FED. SEC. L. REP. ¶ 72,131 (1967); *In re* Raftery, S.E.C. Acct. Series Rel. No. 108, CCH FED. SEC. L. REP. ¶ 72,130 (1967); *In re* Kerlin, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966); *In re* Hurdman, S.E.C. Acct. Series Rel. No. 104, CCH FED. SEC. L. REP. ¶ 72,126 (1966); *In re* Roberts & Morrow, S.E.C. Acct. Series Rel. No. 99, CCH FED. SEC. L. REP. ¶ 72,121 (1964); *In re* Stone, S.E.C. Acct. Series Rel. No. 97, CCH FED. SEC. L. REP. ¶ 72,119 (1963); *In re* Wechsler, S.E.C. Acct. Series Rel. No. 94, CCH FED. SEC. L. REP. ¶ 72,116 (1962); *In re* Myers, S.E.C. Acct. Series Rel. No. 92, CCH FED. SEC. L. REP. ¶ 72,114 (1962); *In re* Levison, S.E.C. Acct. Series Rel. No. 91, CCH FED. SEC. L. REP. ¶ 72,113 (1962); *In re* Swartz, S.E.C. Acct. Series Rel. No. 88, CCH FED. SEC. L. REP. ¶ 72,110 (1961); *In re* Bollt & Shapiro, S.E.C. Acct. Series Rel. No. 82, CCH FED. SEC. L. REP. ¶ 72,104 (1959); *In re* Touche, Niven, Bailey & Smart, S.E.C. Acct. Series Rel. No. 78, CCH FED. SEC. L. REP. ¶ 72,100 (1957); *In re* Haskin & Sells, S.E.C. Acct.

the actual number is unknown.²¹³ Because a finding of "wilfulness" is not a prerequisite to disciplinary action by the Commission,²¹⁴ it may issue a suspension order even if the accused has acted in good faith and his integrity is beyond reproach.²¹⁵ Nearly all the temporary suspensions have arisen from negligent audits which resulted in material misstatements of the relevant financial data.²¹⁶ Lack of independence²¹⁷ and nonadherence to, or lack of knowledge of, generally accepted accounting principles²¹⁸ are usually the grounds upon which these suspensions have been based²¹⁸ but cases involving substantial improprieties have resulted in more severe sanctions.

A. Permanent Disqualification

Of the twenty disciplinary proceedings made public,²¹⁹ three resulted in the accountant's permanent suspension from the privilege of practicing before the Commission.²²⁰

It seems obvious that any auditor who would falsely certify that he had conducted a professional examination when he had not done so should not remain in practice before the Commission. In one case, the accountant's certificate stated that he had verified a balance sheet and its supporting schedules, that they were in agreement with the corporate records and that, in his opinion, the statements truly reflected the

Series Rel. No. 73, CCH FED. SEC. L. REP. ¶ 72,092 (1952); *In re Masquelette & Co.*, S.E.C. Acct. Series Rel. No. 68, CCH FED. SEC. L. REP. ¶ 72,087 (1949); *In re Barrow, Wade, Guthrie & Co.*, S.E.C. Acct. Series Rel. No. 67, CCH FED. SEC. L. REP. ¶ 72,086 (1949); *In re Williams & Kingsolver*, S.E.C. Acct. Series Rel. No. 59, CCH FED. SEC. L. REP. ¶ 72,078 (1947); Anonymous, S.E.C. Acct. Series Rel. No. 51, CCH FED. SEC. L. REP. ¶ 72,069 (1945); *In re Bryant*, S.E.C. Acct. Series Rel. No. 48, CCH FED. SEC. L. REP. ¶ 72,066 (1944); *In re Logan*, S.E.C. Acct. Series Rel. No. 28, CCH FED. SEC. L. REP. ¶ 72,046 (1942).

213. RAPPAPORT 23-29.

214. See *In re Haskins & Sells*, S.E.C. Acct. Series Rel. No. 73, CCH FED. SEC. L. REP. ¶ 72,092 (1952).

215. *Id.*; cf. *In re Stone*, S.E.C. Acct. Series Rel. No. 97, CCH FED. SEC. L. REP. ¶ 72,119 (1963).

216. See, e.g., *In re Haskin & Sells*, S.E.C. Acct. Series Rel. No. 73, CCH FED. SEC. L. REP. ¶ 72,092 (1952); *In re F.G. Masquelette & Co.*, S.E.C. Acct. Series Rel. No. 68, CCH FED. SEC. L. REP. ¶ 72,087 (1949); *In re Williams & Kingslover*, S.E.C. Acct. Series Rel. No. 59, CCH FED. SEC. L. REP. ¶ 72,078 (1947).

217. See, e.g., *In re F.G. Masquelette & Co.*, S.E.C. Acct. Series Rel. No. 68, CCH FED. SEC. L. REP. ¶ 72,087 (1949).

218. See, e.g., *In re Haskin & Sells*, S.E.C. Acct. Series Rel. No. 73, CCH FED. SEC. L. REP. ¶ 72,092 (1952).

219. See note 212 *supra*.

220. *In re Levison*, S.E.C. Acct. Series Rel. No. 91, CCH FED. SEC. L. REP. ¶ 72,113 (1962); *In re Swartz*, S.E.C. Acct. Series Rel. No. 88, CCH FED. SEC. L. REP. ¶ 72,110 (1961); *In re Bryant*, S.E.C. Acct. Series Rel. No. 48, CCH FED. SEC. L. REP. ¶ 72,066 (1944).

company's affairs as of the given date.²²¹ The financial statements to which the certificate related were filed with the Commission as part of a registration statement and were materially false and misleading in a number of respects: past due receivables were described as "not yet due" and substantial payments for services to be performed by the company in the future were credited to income as received rather than being accrued. Actually, the accountant had made no audit of the company's books, had no knowledge of its methods of operation and was completely unaware of the contents of its "audited" financial statements. He prepared the certificate without having seen the books or records, using financial statements prepared by the company's bookkeeper, a non-public accountant and a former employe of the defendant. The defendant's unfamiliarity with the rules of the Commission and the standards of his profession were held to be no excuse for his conduct and he was found to have engaged in unethical and unprofessional conduct and was unfit to represent others.²²²

Nor can an auditor continue to "practice" if he knowingly prepares a statement which he reasonably should know is false. In *In re Swartz*,²²³ the accountant provided a corporate officer with ten signed-in-blank copies of his letterhead stationary. The officer had an accountant's certificate typed over the signature and attached the paper to false and fraudulent financial statements which he then circulated. After the accountant learned of the officer's action, he continued to work for the client and prepared a pro-forma balance sheet from figures, which the accountant knew to be fictitious, dictated to him by the officer. He also prepared, but did not certify, other false and misleading financial statements for inclusion in an annual report and a proxy statement to be filed with the Commission. The Commission found the accountant lacking in the high standard of honesty demanded of those who practice before it and disqualified him.²²⁴

The third permanent disqualification involved another accountant who certified the false statements prepared by Swartz in the preceding case.²²⁵ His audit report contained the standard scope paragraph

221 See *In re Bryant*, S.E.C. Acct. Series Rel. No. 48, CCH FED. SEC. L. REP. ¶ 72,066 (1944)

222 *Id.*

223 *In re Swartz*, S.E.C. Acct. Series Rel. No. 88, CCH FED. SEC. L. REP. ¶ 72,110 (1961). It also is significant that the auditor had admittedly lied in testifying before the SEC in the early part of the investigation.

224 *In re Levison*, S.E.C. Acct. Series Rel. No. 91, CCH FED. SEC. L. REP. ¶ 72,113 (1961).

225 *In re Swartz*, S.E.C. Acct. Series Rel. No. 88, CCH FED. SEC. L. REP. ¶ 72,110 (1961).

although the accountant had not conducted an audit and had not seen the books and records to which his certificate related. Among the statements which he certified was one he copied from a draft prepared by a corporate officer (the same officer involved in the *Swartz* case) and another which he copied (with material revisions) from a statement certified by the defendant in *Swartz*. In suspending the accountant, the Commission found that he knew the statements would be filed with it and that he had engaged in unprofessional conduct.²²⁶

In each of these cases, criminal intent to defraud could, if needed, be imputed through recklessness; for purposes of the securities laws the accountants knew what they were doing and that they were making false factual representations. In the first case, prosecution on false statements or mail fraud grounds would also have been possible; in the second, mail fraud and conspiracy and conceivably aiding and abetting in the submission of false statements; and in the third case, prosecution on *any* of these grounds would appear to have been appropriate.

B. Indefinite Suspension

Two disciplinary proceedings have resulted in suspension of an accountant's privilege to practice before the Commission until such time as the Commission itself should determine otherwise.²²⁷ In *In re Myers*,²²⁸ an accountant prepared a balance sheet showing a net worth in excess of \$800,000 from information he received over the telephone from a corporate officer and former client of his firm. He then wrote a cover letter on his firm's stationery in which he represented that he had reviewed the company's books and records and had prepared the balance sheet after such examination. In fact, the accountant had never seen any of the corporation's books and records and his sole source of information for the statement was the telephone call. The balance sheet was false and fraudulent and was used by the company to acquire a \$100,000 bank loan and to secure a favorable credit rating. The accountant was found guilty of unethical and unprofessional conduct and suspended from practice before the Commission for a potentially indefinite period.²²⁹ Although the conduct in this case was analogous

226. *In re Levison*, S.E.C. Acct. Series Rel. No. 91, CCH FED. SEC. L. REP. ¶ 72,113 (1961).

227. *In re Myers*, S.E.C. Acct. Series Rel. No. 92, CCH FED. SEC. L. REP. ¶ 72,114 (1962); *In re Bollt & Shapiro*, S.E.C. Acct. Series Rel. No. 82, CCH FED. SEC. L. REP. ¶ 72,104 (1959).

228. *In re Myers*, S.E.C. Acct. Series Rel. No. 92, CCH FED. SEC. L. REP. ¶ 72,114 (1962).

229. *Id.* Somewhat less than three years later, the Commission ordered that Myer's privilege of practicing before it be reinstated. *In re Myers*, S.E.C. Acct. Series Rel. No. 101, CCH FED. SEC. L. REP. ¶ 72,123 (1965).

to that in the previous subsection, it is easily distinguishable in that nothing which the defendant prepared was submitted to or acted upon by the Commission or its staff. This distinction may have been the basis for the lesser penalty imposed here, as evidenced by the treatment given the accountant in the *In re Bollt & Shapiro* case.

In *In re Bollt & Shapiro*,²³⁰ the senior partner of an accounting firm was also principle promoter, officer, director and stockholder of a corporation whose financial statements he caused his partner to certify for inclusion in a registration statement. Bollt signed the registration statement as a principle officer and director but did not disclose his relationship to the certifying accountant as required by Form S-1.²³¹ Under "company management," he disclosed in detail his activities and associations but, in stating that he was engaged in active practice as a certified public accountant, did not reveal the name of his firm. The accountant's certificate was written on blank paper because the corporation's address was identical to that of the partnership. The corporate attorney, without Shapiro's knowledge, typed in the latter's home address. The Commission found that Bollt had intended to deceive it and indefinitely suspended him and the firm from practicing before it.²³² The certifying accountant was held not to have intended to deceive the Commission²³³ but because he knew that he was certifying for inclusion in a registration statement under circumstances in which he was not independent, he was suspended for thirty days.²³⁴

Bollt's suspension was less than would have been anticipated since he disclosed a character inconsistent with that of the public accounting profession and had violated its rules of ethics and professional conduct.²³⁵ The only apparent reason for the Commission's leniency was that it acted before third parties had been injured. However, the Commission may have indirectly achieved the same result as it would

230. *In re Bollt & Shapiro*, S.E.C. Acct. Series Rel. No. 82, CCH FED. SEC. L. REP. ¶ 72,104 (1959).

231. Form S-1, Part II, Item 24 and instruction, 17 C.F.R. 239.11 (1968).

232. *In re Bollt & Shapiro*, S.E.C. Acct. Series Rel. No. 82, CCH FED. SEC. L. REP. ¶ 72,104 (1959). Bollt and the firm were indefinitely suspended, but after two years Bollt was ordered reinstated. *In re Bollt & Shapiro*, S.E.C. Acct. Series Rel. No. 87, CCH FED. SEC. L. REP. ¶ 72,109 (1961).

233. *In re Bollt & Shapiro*, S.E.C. Acct. Series Rel. No. 82, CCH FED. SEC. L. REP. ¶ 72,104 (1959).

234. *Id*.

235. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, RULES OF PROFESSIONAL ETHICS, Rule 10 (rev. 1964).

have with a more severe decision. Under the circumstances, the state regulatory agency *might* order a permanent revocation of the defendant's certificate and license to practice²³⁶ which would preclude his future reinstatement before the Commission.²³⁷

C. *Voluntary Resignation From Practice*

There have been seven cases in which the accountant has voluntarily resigned from practice before the Commission.²³⁸ All but one of these cases have occurred since 1962, possibly indicating a new enforcement policy of the Commission. Voluntary resignation is significant because it does not constitute an admission of any charges brought against the accountant.²³⁹ Because he has not been officially suspended by the Commission, the defendant may not have his certificate revoked or suspended by his state board of accountancy.²⁴⁰ However, a voluntary resignation from practice before this federal agency might cause independent investigation by the state agency into the facts underlying the accountant's resignation.

In such cases, the Commission apparently feels no need for a hearing and the accompanying expense.²⁴¹ Since only two of the seven resignation cases have disclosed the facts uncovered by the

236. The state of Bollt's certification was Maryland. See *In re Bollt & Shapiro*, S.E.C. Acct. Series Rel. No. 82, CCH FED. SEC. L. REP. ¶ 72,104 (1959). In Maryland, the cancellation or suspension of an auditor's privilege to practice before any state or federal agency is a statutory ground for suspension or revocation of his certificate. MD. ANN. CODE art. 75A, § 11(a)(4) (1957).

237. The Commission will not recognize a person as a Certified Public Accountant if he is not registered as such and in good standing under the laws of the place of his residence or principal office, or as a public accountant a person who is not in good standing and entitled to practice under the laws of his residence or principal office. Regulation S-X, 17 C.F.R. 210.2-01(a) (1968). See also *National Elec. Signal Co.*, 8 S.E.C. 160, 166 (1940). The foregoing are, of course, the only types of accountants who are permitted to practice before the Commission. See Regulation S-X, 17 C.F.R. 210.2-01(a) (1968).

238. *In re Weiner*, S.E.C. Acct. Series Rel. No. 110, CCH FED. SEC. L. REP. ¶ 72,132 (1968); *In re Aronowitz*, S.E.C. Acct. Series Rel. No. 109, CCH FED. SEC. L. REP. ¶ 72,131 (1967); *In re Raftery*, S.E.C. Acct. Series Rel. No. 108, CCH FED. SEC. L. REP. ¶ 72,130 (1967); *In re Kerlin*, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966); *In re Hurdman*, S.E.C. Acct. Series Rel. No. 104, CCH FED. SEC. L. REP. ¶ 72,126 (1966); *In re Wechsler*, S.E.C. Acct. Series Rel. No. 94, CCH FED. SEC. L. REP. ¶ 72,116 (1962); *Anonymous*, S.E.C. Acct. Series Rel. No. 51, CCH FED. SEC. L. REP. ¶ 72,069 (1945).

239. *In re Kerlin*, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966). But see *Anonymous*, S.E.C. Acct. Series Rel. No. 51, CCH FED. SEC. L. REP. ¶ 72,069 (1945).

240. See, e.g. CAL. BUS. & PROF. CODE § 5100(h) (1960); MD. ANN. CODE art. 75A, § 11(a); MO. REV. STAT. § 326.130(6) (1966).

241. See *In re Kerlin* S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966).

Commission's investigation,²⁴² and there often is no formal finding,²⁴³ this alternative may have been made available as a means of inducing the accused to save whatever face he can while at the same time protecting the public interest.

In one case,²⁴⁴ the accountant's client was a corporate broker-dealer. The audit report represented that the accountant had reviewed its accounting records and procedures, analyzed and verified all its accounts containing debit or credit balances, and examined and verified all securities and cash items underlying the accounts of its customers, brokers, and officers, as well as its inventory and trading accounts in accordance with generally accepted auditing standards applicable to brokers.

The accountant admitted being familiar with a Commission rule establishing minimum audit procedures for engagements involving broker-dealers,²⁴⁵ but he did not observe it. He failed to: (1) verify securities in transit; (2) investigate the ownership of hypothecated securities; (3) analyze customers accounts; (4) evaluate the system of internal accounting and asset controls; and (5) confirm directly bank balances and loans payable to banks, as well as to make inquiry of banks as to existing liabilities unrecorded by his client. Apparently, he issued a favorable report—because the Commission emphasized that in reality, all was not well with the company.²⁴⁶ It was insolvent; its customers' securities had been wrongfully used to collateralize its bank loans or the debts of its officer to the company; and, certain of its notes payable and the applicable collateral had not been recorded either as liabilities or as hypothecated assets.

The accountant admitted these facts but the Commission, feeling that his substandard audit had in no way contributed either to the frauds perpetrated by his client or in losses to his client's customers,²⁴⁷

²⁴² Compare *id.* and Anonymous, S.E.C. Acct. Series Rel. No. 51, CCH FED. SEC. L. REP. ¶ 72,069 (1945), with *In re* Weiner, S.E.C. Acct. Series Rel. No. 108, CCH FED. SEC. L. REP. ¶ 72,132 (1968), *In re* Aronowitz, S.E.C. Acct. Series Rel. No. 109, CCH FED. SEC. L. REP. ¶ 72,131 (1967), *In re* Raftery, S.E.C. Acct. Series Rel. No. 108, CCH FED. SEC. L. REP. ¶ 72,130 (1967); *In re* Hurdman, S.E.C. Acct. Series Rel. No. 104, CCH FED. SEC. L. REP. ¶ 72,126 (1966), *In re* Wechsler, S.E.C. Acct. Series Rel. No. 94, CCH FED. SEC. L. REP. ¶ 72,116 (1962).

²⁴³ See *In re* Kerlin, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966).

²⁴⁴ Anonymous, S.E.C. Acct. Series Rel. No. 51, CCH FED. SEC. L. REP. ¶ 72,069 (1945).

²⁴⁵ Exchange Act Rule 17a(5), 17 C.F.R. § 270.17a(5) (1968).

²⁴⁶ Anonymous, S.E.C. Acct. Series Rel. No. 51, CCH FED. SEC. L. REP. ¶ 72,069 (1945).

²⁴⁷ *Id.*

disclosed these facts with the auditor's consent but interestingly refused to disclose the defendant's identity. It did disclose that he was a tax practitioner of some thirty years experience and that this was only his third SEC engagement. Though the audit was quiet substandard, the Commission apparently found no conscious improprieties on the auditor's part and its disposition of the matter, *i.e.*, accepting his voluntary permanent resignation from practice before it and disclosing the facts but not his name, served to protect the interests both of the public investors in securities and the accountant's tax practice.

In re Homer E. Kerlin,²⁴⁸ the other case in which the facts have been disclosed, is significant for many reasons. First, the accountant, his partner and employee of their firm, were charged with conspiracy to violate Section 17(a) of the Securities Act.²⁴⁹ Second, had he not chosen to resign voluntarily, it is almost certain that Kerlin would have been permanently disqualified from Commission practice. Third, it indicates that although it makes no "formal" final determination in the matter, whenever the Commission wishes to insure complete professional censure of the accountant, it will publish his name as well as the facts disclosed by its investigation.

Kerlin's firm certified financial statements for inclusion in an annual 10-K Report filed with the Commission and in a proxy statement required by Section 14 of the Exchange Act.²⁵⁰ The "audited" company's credit arrangements required that it maintain a current ratio of at least 2 to 1 and a net working capital of at least \$2.5 million. For years, its bookkeeper had juggled the books in an effort to meet these prescribed minima and later to surpass them in order to facilitate the public sale of the company's securities and to induce another company to merge with it.²⁵¹ Among other things, the

248. *In re Kerlin*, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966).

249. See *United States v. Olen*, 183 F. Supp. 212 (S.D.N.Y. 1960) (motion for change of venue granted). In a related civil litigation under Rule 10b(5), the accountants were charged with knowingly conspiring with their client to induce the plaintiff company to enter into a merger with it. *H. L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960) (motion to dismiss denied).

Subsequent to the institution of the Commission's investigation of Kerlin and Childree, the latter died. *In re Kerlin*, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966). In accepting Kerlin's resignation, the Commission considered that fact together with the fact that the firm had been dissolved, and Kerlin's apparent agreement to withdraw from the practice of public accounting altogether, and concluded that it would not be inconsistent with the public interest to permit him to do so.

250. *In re Kerlin*, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966).

251. *Id.* See also *H.L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960) (Rule 10b(5) proceeding by the acquiring company).

bookkeeper failed to record invoices covering large quantities of merchandise during the accounting periods in which the related merchandise was received, manipulated and falsified retail inventory records, and charged numerous capital items to expense in order to reduce corporate taxable income. The net effect of these improprieties was an overstatement of net working capital of \$4.7 million, an understatement in vouchers payable of \$2.7 million, a shortage in inventory of \$2.8 million, and an understatement in fixed assets of \$800,000. The Commission's investigatory staff felt that these practices were so slipshod and grossly improper that any professional investigation by a competent, independent public accountant would have disclosed them, a disclosure not revealed by the defendant's audit.²⁵²

For example, in order to understate purchase and liabilities, no entry was made in the voucher register for merchandise as it was received; thus, there was constantly merchandise on hand with its purchase liability unrecorded. Generally accepted auditing procedure requires circularization of all major suppliers, even those to whom no current balance owing is disclosed on the books.²⁵³ If that procedure had been followed in this case, the liabilities would have been disclosed to the auditors. In addition, the inventory receipts and their related invoices were month-keyed by voucher number so that any investigation of the voucher register would have disclosed payment of the previously unrecorded liabilities for merchandise purchased in prior months. The defendant, nevertheless, discovered and/or disclosed none of the improprieties. Moreover, during one inventory count, the quantity "400" was materially altered to read "14,400" thereby also increasing the inventory value by \$1.5 million. Even though he had worked on the company's audit as a staff member, a supervisor, and a partner, the defendant noted no discrepancy and applied no additional auditing procedures to determine if any material variation existed. In fact, he increased the inventory value by an additional \$600,000 so that it would agree with that contained on the company's balance sheet.²⁵⁴ There could be no doubt as to the defendant's awareness of the true state of affairs regarding his client because one of his employees had

252 *In re Kerlin*, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966).

253 STATEMENT 33, at 38.

254. See *In re Kerlin*, S.E.C. Acct. Series Rel. No. 105, CCH FED. SEC. L. REP. ¶ 72,127 (1966)

discovered more than one of the discrepancies and had so informed his employer.²⁵⁵

The Commission's investigatory staff concluded that the defendant's conduct represented a complete abdication of the responsibilities of an independent public accountant.²⁵⁶ The ultimate determination of his criminal prosecution is not known but it appears that he was acquitted. Had he been convicted of a felony, his state board of accountancy would have revoked his certificate and license to practice.²⁵⁷ No longer being a licensed certified public accountant, he would not be qualified to practice before the Commission and the disciplinary proceeding would be superfluous.²⁵⁸ This conclusion is further supported by the fact that neither of the accountants in *United States v. White*²⁵⁹ and *United States v. Benjamin*²⁶⁰ were subject to publicly disclosed disciplinary proceedings. While this does not foreclose the possibility of there having been such hearings, the facts in both cases were significant enough to have warranted public disclosure.

CONCLUSION

To be convicted under any of the federal criminal statutes discussed, an accountant must act either wilfully or intentionally. In interpreting these requirements the courts have sustained convictions in which the defendant's means ranged from negligence to premeditation. The different interpretations depend on both the statute being construed and the particular court construing it. Thus, the imprecise guidelines of Congress are further blurred by the courts' inability or unwillingness to clearly articulate their statutory interpretations. As *United States v. Simon* demonstrates, it is no longer sufficient for the accountant to rely on a reasonable interpretation of standard auditing rules to resolve difficult questions within the gray areas of accounting.

255. *Id.*

256. *Id.*

257. Kerlin's firm was licensed in Alabama. *Id.* Although the Alabama accountancy statute does not explicitly state that a felony conviction is grounds for suspension or revocation of a certificate, ALA. CODE tit. 46, § 6(21)(a) (Supp. 1967), nevertheless, a conviction of conspiracy to violate the anti-fraud provision would undoubtedly be indicative of unprofessional conduct or constitute "other sufficient cause." *Id.*

258. See *supra* note 264; Rule 2-01(a), 17 C.F.R. § 210.2-01(a) (1968). But if he had not been suspended by the state, a disciplinary proceeding under Rule 2(e) would have been necessary to determine whether he had engaged in unethical or improper professional conduct or was otherwise lacking in character or integrity. See Rule 2(e), 17 C.F.R. § 210.2(e)(2) (1968).

259. 124 F.2d 181 (2d Cir. 1941).

260. 328 F.2d 854 (2d Cir. 1964).

If he must rely on the case-by-case sort of analysis followed by the courts, there simply are no specific guidelines which tell the accountant how much he must know to incur liability for an action or how much he must find out to be held harmless for an omission.

The administrative proceedings before the SEC suffer from the same sort of inadequacies. Only those actions which are of "public interest" are reported, and these involve gross violations of the accountants' own standards. However, even in these circumstances, there are no clear guidelines which tell an accountant or his attorney what sanction would be appropriate for particular activities. This *ad hoc* method of determining sanctions, while equitable to the individuals involved, offers no guidelines for the accountant called upon to justify his actions. It is even unclear whether the level of proof or justification changes with the seriousness of the sanction being considered.

There should be a consistent standard applied to accountants involved in securities work. To achieve this consistency, the courts could try to rationalize the statutes or explain their differences. Alternatively, the accounting profession could promulgate standards that would be strict enough to meet the most restrictive criteria found in the decisions. Neither solution seems feasible or likely. A third alternative, at least in the securities context, might be an expansion of the SEC regulations, given the force of law under both the 1933 Securities Act and the 1934 Exchange Act. As the controversy over the lower court decision in *United States v. Simon* illustrates, some solution is called for so that the accountant can at least understand the nature of the obligation society has chosen to impose on him.

ADDENDUM

As this edition was going to press, the Second Circuit Court of Appeals affirmed the convictions in *United States v. Simon*.

